

Taking Stock: Insider and Outsider Trading by Congress

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TAKING STOCK: INSIDER AND OUTSIDER TRADING BY CONGRESS

JEANNE L. SCHROEDER*

ABSTRACT

Spring 2012 saw the enactment of the “Stop Trading on Congressional Knowledge Act of 2012” or “STOCK Act.” It supposedly repealed an exemption from the federal securities laws that made insider trading by members of Congress “totally legal.” As every securities lawyer knows, however, there never was such an exemption. Representatives and Senators have always been subject to the same rules as the rest of us. It is just that insider-trading law is so incoherent that legal scholars sharply disagreed as to when, or even if, trading by government officials on the basis of material nonpublic information gleaned from their positions would be unlawful. It clearly would not constitute “classic” insider trading, and it was not clear if it constituted “misappropriation” or “outsider” trading. Consequently, despite circumstantial evidence that such trading is not unusual, neither the Securities and Exchange Commission nor the Department of Justice has ever brought an insider trader action against a member of Congress.

The STOCK Act was adopted to address a public relations problem. It does not solve the real legal problem—the incoherence of insider-trading case law that had resulted from the fact that the securities laws neither expressly prohibit insider trading generally nor define what it might be. It is unfortunate, therefore, that Congress ducked this golden opportunity to amend the law. Consequently, we are left with the jurisprudential scandal that insider trading is largely a federal common-law offense.

Even after the STOCK Act, it will continue to be difficult to curtail undesirable Congressional trading through insider-trading law. All the STOCK Act does is to try to shed some light on one element of a potential Congressional insider trading case—namely the nature of the relationship of members or employees of Congress to the source of certain nonpublic information. It does not, however, address the numerous other reasons why it is difficult to charge them with insider or outsider trading. Ironically, the most important legacy of the STOCK Act might be that it could be construed as an implicit endorsement of a controversial SEC regulation applicable to other persons.

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INTRODUCTION

In 2012 Congress enacted the Stop Trading on Congressional Knowledge Act of 2012 or STOCK Act.¹ It supposedly repealed an exemption from the federal securities laws² that made insider trading by members of Congress “totally legal.”³ As every securities lawyer knows, however, there never was such an exemption. Representatives and senators have always been subject to the same rules as the rest of us. It is just that insider-trading law is so incoherent that legal scholars sharply disagreed as to when, or even if, trading by government officials on the basis of material, nonpublic information *gleaned from their positions* would be unlawful.⁴ It would not constitute *classic* insider trading, and it was not clear if it constituted *misappropriation*, or *outsider*, trading. Consequently, despite circumstantial evidence that such trading is not unusual,⁵ neither the Securities and Exchange Commission (SEC) nor the Department of Justice (DOJ) has ever brought an insider-trading action against a member of Congress.⁶

The STOCK Act was, in fact, enacted to address a public relations problem—the common misperception that Congress exempted itself from

¹ Stop Trading on Congressional Knowledge Act of 2012 (STOCK Act), Pub. L. No. 112-105, 126 Stat. 291 (2012).

² Donna M. Nagy, *An Interdisciplinary View of Fiduciary Law: Insider Trading, Congressional Officials, and Duties of Entrustment*, 91 B.U. L. REV. 1105, 1107 (2011) [hereinafter, Nagy, *Entrustment*] (citing Tom McGinty & Brody Mullins, *Lawmaker Aims to Outlaw Insider Trading on the Hill*, WALL ST. J., Oct. 12, 2010, at A9). Later journal articles more accurately describe the STOCK Act as “formally” banning certain congressional trading. See, e.g., Michael Rothfeld & Jason Zweig, *House Insider Bill Passes with New Backers*, WALL ST. J., Feb. 10, 2012, at A1.

³ One reporter defended Vice Presidential candidate Paul Ryan against accusations of improper trading partially on these grounds. Kevin Roose, *Paul Ryan Is Not an Insider Trader*, N.Y. MAG. (Aug. 13, 2012, 2:34 PM), <http://nymag.com/daily/intel/2012/08/paul-ryan-not-an-insider-trader.html>.

⁴ See *infra* Part III. Although a group of law students who engaged in an economic analysis of the STOCK Act initially seemed to parrot the sponsors’ assertions that congressional trading was then not illegal, their analysis suggests, more accurately, not that Congress was exempt from the law, but that it was not clear whether the law, as interpreted, was broad enough to cover such trading. See Matthew Barbabella et al., Note, *Insider Trading in Congress: The Need for Regulation*, 9 J. BUS. & SEC. L. 199 (2009). Indeed, in the past, I have occasionally included a question on my Securities Regulations exam based on such a scenario to test my students’ understanding of the vagaries of the law.

⁵ See *infra* notes 15–28.

⁶ Reportedly, the SEC “considered, but rejected, investigating” senatorial trading after the release of a study suggesting that senators reaped abnormal returns because it thought that the cases would be too difficult to win. Joseph N. DiStefano, *Senators’ Stock Picks Bring Profit, Scrutiny*, PHILA. INQUIRER (Nov. 7, 2004), http://articles.philly.com/2004-11-07/business/25378433_1_senators-congressional-business-business-information/2.

the securities laws.⁷ It did not address the real legal problem—the incoherence of insider-trading case law that had resulted from the fact that neither the Securities Exchange Act of 1934 (the '34 Act)⁸ nor the regulations promulgated under it expressly prohibit insider trading generally, let alone define what it might be.⁹ It is unfortunate, therefore, that Congress ducked this golden opportunity either to amend the '34 Act in order to define insider trading or, at least, to give the SEC authority to do so. Consequently, we are left with the jurisprudential scandal that insider trading is largely a federal common-law offense.

Even after the STOCK Act, it will remain difficult to prohibit certain undesirable acts of congressional trading. Current insider-trading law focuses on preventing fraud and promoting market integrity.¹⁰ In contrast, the STOCK Act is primarily worried about the integrity of governmental actors, preventing corruption, or the appearance of corruption.¹¹ It is hard to see how a law

⁷ See Paul D. Brachman, *Outlawing Honest Graft*, 16 N.Y.U. J. LEGIS. & PUB. POL'Y 261, 262, 265-66 (2013).

⁸ Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78pp (2006).

⁹ Rule 14e-3 does address a narrow aspect of insider trading: it imposes a prophylactic rule prohibiting trading by certain persons after “any person has taken a substantial step or steps to commence, or has commenced a tender offer.” 17 C.F.R. § 240.14e-3 (2014).

The SEC has promulgated two controversial rules purporting to clarify certain elements of unlawful trading that have been developed in the case law. See *infra* Part I.A.

As far back as 1995, Stephen Bainbridge, in one of the most insightful articles on the subject stated:

The point remains, however, that the federal insider trading prohibition is a relatively recent administrative and judicial creation lacking any significant statutory basis: “In regulating insider trading under rule 10b-5 the lower federal courts and the SEC have been operating without benefit of support from the legislative history of the 1934 Act or from the language of section 10(b). In plainer words, they have exceeded their authority.”

Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1231 (1995) (citation omitted).

Opponents of a statutory definition of insider trading have argued that it might serve as a “roadmap for fraud.” See, e.g., Stuart J. Kaswell, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 BUS. LAW 145, 150 (1989). Jonathan Macey has suggested that

the SEC in recent years has attempted to expand the contours of the law, which makes it easier for them to bring cases, and to keep the law vague by refusing to define insider trading. The SEC has thus pursued a policy that is consistent with the Commission's rational self-interest but clearly suboptimal from a societal perspective of economizing the performance of investigations.

Jonathan R. Macey, *The Distorting Incentives Facing the U.S. Securities and Exchange Commission*, 33 HARV. J.L. & PUB. POL'Y 639, 646 (2010).

¹⁰ *United States v. O'Hagan*, 521 U.S. 642, 647–58, 687–88 (1997).

¹¹ See *supra* note 7.

developed around the former concerns can be shoehorned into addressing the latter concerns, and the STOCK Act did nothing to add clarity to the situation. Consequently, although the STOCK Act might clarify when congressional trading would violate Congress's *internal* ethical rules, it is still not clear whether the SEC can successfully bring civil actions against, or the DOJ can prosecute, members of Congress and their staffers under the securities laws.

All the STOCK Act does is try to shed some light on one element of a potential congressional insider-trading case, namely the nature of the relationship of members or employees of Congress to the source of certain non-public information. It does not, however, address the numerous other reasons why it is difficult to charge them with insider or outsider trading. Ironically, the most important legacy of the STOCK Act might be that it could be construed as an implicit endorsement of a controversial SEC regulation applicable to *other* persons.

This Article proceeds as follows. I will first give an account of the language of the STOCK Act and some background of insider-trading law generally. This will be followed by a review of the case law applying the misappropriation theory of insider or, more accurately, outsider trading.¹² I then will ask how the STOCK Act can be expected to interact with the current case law.

I. BACKGROUND

It has long been suspected that members of Congress frequently trade on material nonpublic information that they learned from their official positions. Perhaps the most well-known evidence of this, albeit circumstantial, is a study led by Alan J. Ziobrowski indicating that a group of senators beat the market by an average of 12 percent over a five year period,¹³ a return higher than those faked by Ponzi-schemer Bernie Madoff.¹⁴

¹² As I, among others, have covered this subject extensively elsewhere, this discussion will be very brief. See Jeanne L. Schroeder, *Envy and Outsider Trading: The Case of Martha Stewart*, 26 CARDOZO L. REV. 2023 (2005), reprinted with slight alterations as Jeanne L. Schroeder, *Envy and Outsider Trading*, in MARTHA STEWART'S LEGAL TROUBLES (Jean MacLoed Heminway ed., 2007) [hereinafter, Schroeder, *Envy*]. This Article is not intended as a survey of the exhaustive literature on this subject.

¹³ Alan J. Ziobrowski et al., *Abnormal Returns From the Common Stock Investments of the U.S. Senate*, 39 J. FIN. & QUANTITATIVE ANALYSIS 661, 661–62 (2004).

¹⁴ Madoff reported returns that ranged from around 10 to 12 percent, year after year, with what looks retrospectively like suspiciously little variation. Paul Sullivan, *The Rules that Madoff's Investors Ignored*, N.Y. TIMES (July 6, 2009), http://www.nytimes.com/2009/01/06/business/worldbusiness/06iht06wealth.19137611.html?_r=1&pagewanted=all.

Earlier versions of what would eventually become the STOCK Act were introduced to Congress beginning in 2006.¹⁵ The legislation languished until 2011, when *The Wall Street Journal* and the television magazine *60 Minutes* ran exposés of congressional trading.¹⁶ Because of the resulting embarrassment and a call for the law’s adoption by President Barack Obama in his 2012 State of the Union Address,¹⁷ a revised version of the STOCK Act was quickly adopted by lopsided votes of 417–2 in the House and 96–3 in the Senate.¹⁸ In order to achieve this, the bill was gutted, removing an express definition of unlawful trading and provisions relating to the gathering and sale of so-called political information by investment consultants.¹⁹

A. Statutory Framework

1. The STOCK Act

The preamble of the STOCK Act states that its purpose is “to prohibit Members of Congress and employees of Congress from using nonpublic information derived from their official positions for personal benefit, and for other purposes.”²⁰

In Section 4, the STOCK Act affirms that “[m]embers of Congress and employees of Congress are not exempt from the insider trading prohibitions” of the ’34 Act.²¹ This was an attempt at public relations. It was legally unnecessary because it was always clear that the ’34 Act never exempted them. What was unclear was *how* to apply the misappropriation theory of insider trading in the governmental context.

The STOCK Act adds a new subsection to section 21A of the ’34 Act—that is, the section that otherwise provides for civil penalties for violations of the ’34 Act—that recognizes a duty (but for only limited purposes) relating to information learned from a congressional position:

solely for the purposes of the insider trading prohibitions arising under this Act ... each Member of Congress or employee of Congress owes a

¹⁵ *E.g.*, H.R. 5015, 109th Cong. (2006).

¹⁶ Brody Mullins et al., *Congress Staffers Gain from Trading in Stocks*, WALL ST. J. (Oct. 11, 2010), at A1; *Congress: Trading Stock on Inside Information?*, 60 MINUTES (Nov. 13, 2011), <http://www.cbsnews.com/video/watch/?id=7388130n>.

¹⁷ Barack Obama, President of the United States of America, *State of the Union Address, “An America Built to Last”* (Jan. 24, 2012), http://www.cspan.org/uploadedFiles/Content/The_Administration/State_of_the_Union/SOTU-2012.pdf.

¹⁸ Robert Pear, *Insider Trading Ban for Law Makers Clears Congress*, N.Y. TIMES, Mar. 22, 2012, at A13.

¹⁹ *Compare* Stop Trading on Congressional Knowledge Act of 2012 (STOCK Act), Pub. L. No. 112-105, 126 Stat. 291 §5 (2012) with S. 1903, 112th Cong. §5 (2011).

²⁰ Stop Trading on Congressional Knowledge Act of 2012 (STOCK Act), Pub. L. No. 112-105, 126 Stat. 291 (2012).

²¹ *Id.* § 4(a).

duty arising from a relationship of trust and confidence to the Congress, the United States Government, and the citizens of the United States with respect to material, nonpublic information derived from such person's position as a Member of Congress or employee of Congress or gained from the performance of such person's official responsibilities.²²

But the Act does not hash out specific rules for what sort of information is subject to this duty, or otherwise clarify the relation to insider trading. Instead, it leaves this to each chamber's ethics committees, stating that the respective ethics committee of each House shall issue interpretive guidelines of the relevant rules.²³

The Act also directs the Office of Government Ethics and the Judicial Conference of the United States to adopt clarifying rules concerning trading on material, nonpublic information by members and employees of the executive and judicial branches, respectively.²⁴

An earlier version of the Act contained language that was both broader and more specific. It directed the SEC, not the Ethics Committees of each chamber, to adopt prophylactic rules prohibiting

any person from buying or selling the securities of any issuer while such person is in possession of material nonpublic information, as defined by the [SEC], *relating to any pending or prospective legislation action relating to such issuer* if (1) such information was obtained by reason of such person being a Member or employee of Congress; or (2) such information was obtained from a Member or employee of Congress, and such person knows that the information was so obtained.²⁵

2. *The Securities Exchange Act of 1934*

Temporarily leaving aside the question of what it could mean for something to be confidential for *only* one specific purpose, the first ambiguity of the operative language is the reference to “the insider trading prohibitions arising under the” ’34 Act. The ’34 Act never refers to “insider trading” *per se*, except in the titles to section 20A—Liability to Contemporaneous Traders of Insider Trading²⁶—and section 21A—Civil Penalties for Insider Trading.²⁷ As their titles suggest, section 20A allows contemporaneous traders to bring private causes of action against insider traders and section 21A allows the

²² *Id.* § 4(b) (emphasis added).

²³ *Id.* § 3.

²⁴ *Id.* § 9(a).

²⁵ Stephen M. Bainbridge, *Insider Trading Inside the Beltway*, 36 J. CORP. L. 281, 305 (2011) (quoting H.R. 682, 111th Cong. § 2(a) (2009)).

²⁶ 15 U.S.C. § 78t-1 (2006).

²⁷ *Id.* § 78u-1.

SEC to bring civil actions against insider traders. Only section 21A, relating to SEC civil actions, is amended by the STOCK Act, implying that contemporaneous traders will have no private right of action against members of Congress or their staffers.

Sections 20A and 21A impose liability to those who violate “any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information”²⁸ Unfortunately, neither of these sections,²⁹ nor any other provision of the ’34 Act, deigns to give any hint as to *when* trading in securities violates the Act in a context other than tender offers, which are subject to the prophylactic prohibitions of Rule 14e-3.³⁰ Consequently, the Supreme Court has held that, in order to be unlawful, trading must fall under the catchall provisions of section 10(b) of the ’34 Act, which only prohibits actual fraud.³¹

The language of the STOCK Act’s provision giving members of Congress and their staffers a “duty of trust and confidence” alludes (albeit, imperfectly) to the language of Rule 10b5-2³² promulgated by the SEC under

²⁸ *Id.* § 78t-1. The parallel language of section 21A is virtually identical, differing only in that it also refers to trading in security-based swaps. Section 21A also covers tipping, here similarly cryptically described as a violation of “any such provision by communicating such information in connection with, a transaction on or through the facilities of a national securities exchange or from or through a broker or dealer” *Id.* § 78u-1.

²⁹ Earlier versions of these statutory provisions did contain definitions of insider trading but they were omitted in the final acts because

the court-drawn parameters of insider trading have established *clear* guidelines for the vast majority of traditional insider trading cases, and . . . a statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law.

H. COMM. ON ENERGY AND COMMERCE, INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT OF 1988, H.R. Rep. No. 100-9010, at 11 (2d Sess. 1988) (emphasis added), reprinted in 1988 U.S.C.C.A.N. 6043, 6063. See also Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1368 (2009) [hereinafter Nagy, *Fiduciary Principles*]. As will be discussed throughout this Article, in fact the contours of the misappropriation theory of insider trading are as clear as mud.

³⁰ 17 C.F.R. § 240.14e-3 (2014).

³¹ *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977). Consequently, Stephen Bainbridge correctly refers to the incoherence of insider-trading law as the “Santa Fe problem.” STEPHEN M. BAINBRIDGE, *SECURITIES LAW INSIDER TRADING* 65 (2d ed. 2007) [hereinafter, BAINBRIDGE, *INSIDER TRADING*]. As I will discuss, both classic-insider and misappropriation-outsider trading law, as developed in fact, prohibit self-dealing by disloyal agents in the *intellectual property* of their principals. See Sullivan, *supra* note 14; see also *infra* note 72 and accompanying text. However, *Santa Fe* holds that breaches of fiduciary duties *per se* are not violations of section 10(b) and Rule 10b-5. Consequently, the Supreme Court requires judges to pretend that it is the trader’s lies (non-disclosure) to the source of information that is the harm, rather than the trading itself. BAINBRIDGE, *INSIDER TRADING*, *supra* at 65.

³² SEC Rules Relating to Debt Collection, 17 C.F.R. § 240.10b5-2 (2000).

section 10b(5), in an attempt to restrain judicially imposed limitations on insider-trading liability. Unfortunately, as I shall discuss, the legal status of this regulation is uncertain because its language is arguably broader than that adopted by the Supreme Court.³³

It is not clear that this provision will significantly clarify when congressional trading is unlawful. Consequently, with respect to congressional trading, it is another provision that may be more important as a practical matter. Section 6 will require members and staff to publicly report all trading in publicly issued securities within forty-five days.³⁴ This might have some shaming effect that will discourage them from trading in corporations that would be affected by pending legislation or where there seems to otherwise be blatant conflicts of interest. Or to put this more gently, it might increase awareness that some securities trading by public officials, whether or not unlawful, is widely considered to be unseemly.

B. The Theory of Insider Trading

1. The Insider-Trading Puzzle

Ignorance about insider-trading law is rife among not only lay people, but also attorneys who do not practice securities law. The lack of any express statutory or regulatory definition for what constitutes insider trading—other than for the limited case of tender offers—makes the law unclear. Additionally, most purchases and sales of property—even of securities—based on non-public information—are perfectly legal. With a little thought, one should realize that this must be the case. In the immortal words of R. Foster Winans, the primary defendant in the seminal misappropriation case of *Carpenter v. United States*: “The only reason to invest in the market is because you think you know something others don’t.”³⁵ That is, one does not have to be a doctrinaire adherent in the Efficient Capital Markets Hypothesis³⁶ to understand that if you are buying stock because you think that its price is going up, or you are selling because you think it is going down, you must believe that you know something that the market does not. Otherwise this information would already be embedded in the stock price. Indeed, the entire securities-analysis

³³ See *infra* Part I.B.

³⁴ Stop Trading on Congressional Knowledge Act of 2012 (STOCK Act), Pub. L. No. 112-105, § 6, 126 Stat. 291, 293–94 (2012).

³⁵ *Thoughts on the Business of Life*, FORBES.COM, <http://thoughts.forbes.com/thoughts/r-foster-winans> (last visited Jan. 12, 2014); see also *Carpenter v. United States*, 484 U.S. 19 (1987).

³⁶ For the classic statement of the ECMH, see Eugene Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970).

business is based on trying to discover, develop, and sell information ahead of the market.

But more importantly, rather than adopting a parity-of-information regime, our society usually permits people to exploit informational asymmetries when purchasing and selling assets.³⁷ Indeed, informational advantages are typically protected as trade secrets, and are often analyzed as a form of intellectual property.³⁸ As we shall see, the U.S. Supreme Court has based its misappropriation theory of unlawful trading *precisely* upon just such a property analysis.³⁹

For example, in the early insider-trading case of *SEC v. Texas Gulf Sulphur*, initial testing indicated that a publicly traded company may have made an extremely rich mineral strike on property it owned in Canada.⁴⁰ Texas Gulf Sulphur tried to keep this material information secret for as long as practical while further testing was done, so that it could buy contiguous real estate from its ignorant neighbors at an attractive price.⁴¹ As the Court of Appeals for the Second Circuit noted, this was perfectly “legitimate” under the common law principles that underlie Canadian and American law.⁴²

And yet, the Second Circuit held that it would be unlawful insider trading for officers and directors of the Company to purchase shares of the Company’s stock during the time that the material information remained a

³⁷ This is why James Boyle suggests that insider trading is a “puzzle.” James Boyle, *A Theory of Law and Information: Copyright, Spleens, Blackmail, and Insider Trading*, 80 CAL. L. REV. 1413, 1417 (1992).

³⁸ As Henry G. Manne states rather sharply, but accurately: “Lawyers especially, it would seem, should be very circumspect about characterizing the utilization of superior information as immoral. That is, after all, their stock in trade.” Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 551 (1970).

Although in *Carpenter* the Supreme Court seemed to think that the analysis of information as property was unproblematic, in fact, as I have discussed elsewhere, its proper characterization is highly contested. See generally Jeanne L. Schroeder, *Unnatural Rights: Hegel’s Theory of Personality and Intellectual Property*, 60 U. MIAMI L. REV. 453 (2006) (republished as *Unnatural Rights: Hegel’s Theory of Personality and Intellectual Property*, in COPYRIGHT (Christopher Yoo ed., EDWARD ELGAR PRESS 2011) [hereinafter Schroeder, *Unnatural Rights*]). Accordingly, Vincent Chiappetta asks rhetorically:

Is trade secret law a chameleon with the ability to appear varyingly as an almost full-fledged property right, a quasi-property right or a duty of confidence depending on its environment? Or perhaps nothing is actually there but a powerful legal myth?

Vincent Chiappetta, *Myth, Chameleon or Intellectual Property Olympian? A Normative Framework Supporting Trade Secret Law*, 8 GEO. MASON L. REV. 69, 70 (1999).

³⁹ See *Carpenter*, 50 U.S. at 25–26.

⁴⁰ *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

⁴¹ *Id.* at 843–44.

⁴² *Id.* at 848.

secret.⁴³ Why the difference? Why indeed do we find, in James Boyle's words, this "island of egalitarianism at the very heart of capitalism"?⁴⁴

2. *The Harm to Be Prevented*

Another reason for confusion about unlawful insider and outsider trading is that, although there is a widespread intuition that it is wrong—at least some of the time—there is little consensus within the securities bar and academia as to just what is wrong with it. A recent empirical study by Stuart Green and Matthew Kugler suggested a similar confusion among lay people.⁴⁵ They do not like insider trading, even though they, typically, do not really know what it is or why they do not like it.⁴⁶

In a recent article, Samuel Buell accuses the courts of "duck[ing] the question of its purpose within the scheme of securities regulation" of Rule 10b-5 generally and resorting to "bromides;"⁴⁷ a harsh, yet justified, assessment.

I am one of many who have trod this ground before, so I will be brief.⁴⁸ To simplify, proponents of bans on insider trading tend to speak in terms of fairness. The title of an early article by Kim Lane Sheppele probably best captures the lay intuition about insider trading—*It's Just Not Right*.⁴⁹ A fairness rationale for what has become the abstain-or-foreclose rule was initially adopted by the SEC in the early administrative action of *Cady, Roberts & Co.*⁵⁰ The Second Circuit adopted a similar rationale in *Texas Gulf Sulphur*, finding a "justifiable expectation of the securities marketplace

⁴³ *Id.* at 849. The Supreme Court subsequently rejected the fairness and parity-of-information rationales of *Texas Gulf Sulphur* in *Chiarella v. United States*, 445 U.S. 222 (1980).

⁴⁴ Boyle, *supra* note 37, at 1491.

⁴⁵ Matthew P. Green & Matthew B. Kugler, *When is it Wrong to Trade Stocks on the Basis of Inside Information? Public Views of the Morality of Insider Trading*, 39 FORDHAM URB. L.J. 445, 484 (2011).

⁴⁶ *Id.*

⁴⁷ Samuel W. Buell, *What is Securities Fraud?*, 61 DUKE L. J. 511, 572, 568 (2011).

⁴⁸ For example, Bainbridge, writing in 1995, identifies three rationales in the academic literature. First, it supplements the mandatory disclosure system. Second, it protects investors. Third, it provides confidence in the markets. Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1234–42 (1995). The second of Bainbridge's rationales is similar to what I call fairness, and the third to what I call market integrity. I am in basic agreement with Bainbridge's dismissal of the fairness and market integrity rationales, but I am more sympathetic with the first. Schroeder, *Envy*, *supra* note 12.

⁴⁹ Kim Lane Scheppelle, "*It's Just Not Right*": *The Ethics of Insider Trading*, 56 LAW & CONTEMP. PROBS. 123 (1993).

⁵⁰ *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

that all investors trading on impersonal exchanges have relatively equal access to material information.”⁵¹

One problem with this approach is that American law does not generally impose a parity-of-information type fairness standard in markets generally. Consequently, in *Chiarella v. United States*, the majority of the Supreme Court rejected the parity-of-information policy that underlaid the fairness rationale for insider trading.⁵² The Court held that mere possession of material, nonpublic information does not impose limitations on trading absent a fiduciary-type relationship with the source of the information:

First, not every instance of financial unfairness constitutes fraudulent activity under § 10(b). Second, the element required to make silence fraudulent—a duty to disclose—is absent in this case. No duty could arise from petitioner’s relationship with the sellers of the target company’s securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.⁵³

This line of reasoning was expanded in *Dirks v. SEC*, in which the Supreme Court held that mere possession of nonpublic information did not impose a duty on a tippee not to trade in securities.⁵⁴ Rather, a tippee’s liability was held to be derivative of that of his tipper, which, in turn, required that the tipper violated a fiduciary duty to the source of the information. As the Court explained:

Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing

⁵¹ *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968). The Second Circuit stated that it was “the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks...” *Id.* at 851–52.

⁵² *Chiarella v. United States*, 445 U.S. 222, 233 (1980). Although the Supreme Court did not deny that section 10(b) is rooted in a conception of fairness, it insisted that “not every instance of financial unfairness constitutes fraudulent activity under § 10(b).” *Id.* at 232.

⁵³ *Id.* at 232–33 (citations omitted).

⁵⁴ *Dirks v. SEC*, 463 U.S. 646, 658–59 (1983). That is, outsiders may become fiduciaries of the shareholders [but the] basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes. *Id.* at 655 n. 14; *see also id.* at 657–58.

the information to the tippee and the tippee knows or should know that there has been a breach.⁵⁵

In contrast, critics who question the wisdom or efficacy of limits on insider trading tend to speak in terms of market efficiency.⁵⁶ In this view, permitting insiders to trade would incentivize the dissemination of information to the market.

Justice Ginsburg in *United States v. O'Hagan*—the case in which the Supreme Court first embraced the misappropriation theory of insider trading—asserts that both the classic and misappropriation theories of fraud serve the slightly different goals of market integrity and investor protection.⁵⁷ This market-integrity justification has both a fairness and efficiency component. In *O'Hagan*, Justice Ginsburg states:

Although informational disparity is inevitable in securities markets, investors likely would hesitate to venture their capital in a market where trading on misappropriated nonpublic information is unchecked by law. An investor's informational disadvantage vis-à-vis a misappropriator with material, nonpublic information stems from a contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill.⁵⁸

That is, if investors believed that the market was rigged (that is, unfair) they would flee the market, thus making it less efficient. One commentator has recently gone so far as to suggest that if insider trading were legalized, “[s]tock markets would drastically shrink if not disappear.”⁵⁹ Both these views seem to implicitly presume that the goal of investing in the securities market is to make a quick profit by beating the market prior to sudden changes in prices, rather than long-term growth.

Notoriously, one of the problems of all of these approaches goes beyond the fact that the '34 Act does not define insider trading. Although strong arguments have been made that the regulatory scheme of the two primary

⁵⁵ *Id.* at 660. In addition, the tipper must have an improper purpose for breaching his duty to his source. The “insider [must] personally ... benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.” *Id.* at 662.

⁵⁶ The efficiency argument for permitting insider trading was kicked off by Henry G. Manne in his book, *Insider Trading and the Stock Market* (1966). See Manne, *supra* note 38. For a quick survey of the economic arguments for and against limits on insider trading, see Barbabella et al., *supra* note 4, at 227–35.

⁵⁷ *United States v. O'Hagan*, 521 U.S. 642, 653 (1997).

⁵⁸ *Id.* at 658–59.

⁵⁹ George W. Dent, Jr., *Why Legalized Insider Trading Would Be a Disaster* 1 (Case Research Paper Series in Legal Studies, Working Paper No. 2012-36, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2169975.

securities acts should serve the broad purposes of fairness, efficiency, and market integrity, no operative provision of either act speaks directly to such goals. Consequently, the Supreme Court has held that if they are to be unlawful, insider and outsider trading must fall within the basket clause of section 10(b)(5) of the '34 Act, which proscribes "any manipulative or deceptive device or contrivance."⁶⁰ Moreover, since the retrenchment cases of the mid-1970's, the Court has insisted that securities fraud is not constructive fraud, but actual fraud—the tort of deception.⁶¹

It has not been clear how to fit the square pegs of fairness, efficiency, and market integrity into the round hole of actual fraud.⁶² Regardless of whether all fraudulent acts are unfair, not all unfair acts are fraudulent. If efficiency is defined, as it frequently is in legal academia, in terms of maximization of some appropriate desideratum such as utility, productivity, or wealth, then it is possible that some non-fraudulent acts might be inefficient and some fraudulent acts might be efficient. Further, many, including myself, are suspicious of the unsupported empirical assertion that a ban on insider trading is necessary for the sake of market integrity on the grounds that otherwise investors would flee the market.⁶³ If anything, the meager evidence can be read as an indication of the widespread suspicion that insider trading often occurs has had little effect on market participation.⁶⁴

⁶⁰ 15 U.S.C.A. § 78j(b) (West 2013).

⁶¹ 521 U.S. at 654. This is exacerbated by the fact that, because the Supreme Court has approached securities fraud generally, and insider trading specifically, in a classic, common law, piecemeal manner, it has never given a single, clear statement of all of the elements of a cause of action. *Id.*

⁶² In the words of Donald C. Langevoort, the confusion in how we define unlawful insider trading [results from] the quixotic effort to build a coherent theory of insider trading by reference to the law of fraud, rather than a more expansive market abuse standard.... That is intellectually awkward because there is relatively little about unlawful insider trading that can fairly be considered deceptive, yet deception is the essence of fraud. The result is a crazy-quilt of made-up doctrinal innovations

Donald C. Langevoort, *What Were They Thinking? Insider Trading and the Scierter Requirement*, in RESEARCH HANDBOOK ON INSIDER TRADING 2 (Stephen M. Bainbridge ed., 2012).

⁶³ Schroeder, *Envy*, *supra* note 12, at 2068.

⁶⁴ To give the devil his due, Henry G. Manne argues that there is an easy way to test which side is correct in the case of classic insider trading. That is, we could allow a publicly traded company to give its management and employees permission to engage in classic insider trading so long as the company publicly disclosed this policy. If investors react by dumping the stock of companies that do so, we have evidence that the net effect of allowing such trading does hurt market confidence, and that Congress should consider banning this practice. If investors do not dump the stock, it would suggest that the current ban is unnecessary and perhaps inefficient. *See generally* Manne, *supra* note 38.

Finally, the policies that insider-trading law are supposed to address are different from the concerns that led to the STOCK Act. I will return to this divergence.

3. *Intellectual Property*

Both Stephen Bainbridge and I argue that, although the courts ostensibly speak of fraud and integrity, insider-trading law, as actually applied, is based on the allocation of property rights in nonpublic information (for example, trade secrets).⁶⁵ Both the classic and misappropriation theories analyze insider trading as a form of self-dealing in a principal's property by a disloyal agent,⁶⁶ suggesting that restrictions on trading should be limited to persons who have a *fiduciary-type* duty to the source of the information.⁶⁷ Although this is implicit in the jurisprudence of classic insider trading, the Supreme Court has made this express in the case of misappropriation (as the terminology makes clear). Justice Ginsburg states in *O'Hagan*:

A company's confidential information ... qualifies as property to which the company has a right of exclusive use. The undisclosed misappropriation of such information, in violation of a fiduciary duty, ... constitutes fraud akin to embezzlement—"the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another."⁶⁸

⁶⁵ See Schroeder, *Envy*, *supra* note 12, at 2027. Writing in 1995, before *O'Hagan*, Steven Bainbridge wrote:

If one accepts protection of property rights as the rationale for regulating insider trading, it becomes quite difficult to discern any compelling federal interest in doing so. The property rights rationale makes it obvious that the federal insider trading prohibition has nothing to do with disclosure or fraud. Instead, like the trade secrets rules, the insider trading prohibition is mainly concerned with preventing employees and other fiduciaries from using information belonging to the corporation for personal gain. As such, the prohibition is unrelated to the traditional purposes of the securities laws. Indeed, the prohibition is arguably inconsistent with the federalism policies of those laws.

Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1257 (1995).

⁶⁶ As stated in the *Restatement of Agency*:

An agent has a duty not to acquire a material benefit from a third party in connection with transactions conducted or other actions taken on behalf of the principal or otherwise through the agent's use of the agent's position.

RESTATEMENT (THIRD) OF AGENCY § 8.02 (2006).

⁶⁷ As discussed below (*see infra* notes 79–81), the extent to which insider trading liability is or should be restrained by a fiduciary requirement has become controversial.

⁶⁸ *United States v. O'Hagan*, 521 U.S. 642, 654 (1997) (citations omitted) (citing *Carpenter v. United States*, 484 U.S. 19, 25–27 (1987) (quoting *Grin v. Shine*, 187 U.S. 181, 189 (1902))).

When an owner entrusts property to an agent, the agent has a duty not to take and use the property for his own purposes.⁶⁹ Ginsburg concluded from this that, if the agent intends to self-deal in the property, he has a duty to tell his source—the property owner. Not to do so is fraud in that the unfaithful confidant has “feign[ed] fidelity.”⁷⁰ The use of proprietary information is a misappropriation, because it deprives the source of its *exclusive* use of the information—which is the definition of possession of information.⁷¹

This means that, under this theory, it is not enough that a source gives information to a confidant; the source must have some *proprietary* right in the information.⁷² Consequently, given that property is traditionally the bailiwick

⁶⁹ See RESTATEMENT (THIRD) OF AGENCY § 8.05 (2006).

⁷⁰ 521 U.S. at 655.

⁷¹ 521 U.S. at 652, 654.

⁷² To date, the courts have held that violation of property rights in information is a necessary, but not sufficient, element of insider trading. Consequently, in *SEC v. Yum*, 327 F.3d 1263 (11th Cir. 2003), the Court of Appeals for the Eleventh Circuit rejected the SEC’s contention that the misappropriation theory was grounded *solely* on the protection of property rights:

To the extent that the securities laws are premised upon a property rights doctrine, we agree that unauthorized disclosure that harms the principal constitutes a breach of a duty of loyalty and confidentiality. However, the securities laws are not based on property rights alone. An “animating purpose” of the Exchange Act is to “[e]nsure honest securities markets and thereby promote investor confidence.” For this reason, trading on material, nonpublic information (not just possessing, disclosing, or stealing) is essential to incur insider trading liability. Judge Winter ... has advocated a property rights approach to insider trading laws. While his views make practical sense, we cannot ignore the fact that insider trading prohibitions, in the end, must be premised on fraud.

Id. at 1277 n.31 (citation omitted) (quoting *United States v. O’Hagan*, 521 U.S. 642, 658 (1997) (citing *Tender Offers*, 45 Fed. Reg. 60,410, 60,412 (Sept. 12, 1980) (to be codified at 17 C.F.R. pt. 240))). The Court continued:

Judge Winter’s statement ... that the misappropriation theory’s purpose “is to protect property rights in information”—is therefore incomplete in that it ignores the fact that the theory’s essential purpose must be the prevention of fraud.

Id. at 1277 n.31 (citation omitted) (citing *United States v. O’Hagan*, 521 U.S. 642, 655 (1997), for the proposition that “the misappropriation theory is consistent with § 10(b) because it involves ‘manipulation or deception’”).

Similarly, in *SEC v. Rorech*, 720 F. Supp. 2d 367, 373 (S.D.N.Y.2010), one of the reasons the Southern District of New York found for the defendants in a bench trial was because the SEC did not establish fraud:

[D]eceipt—or the unauthorized theft of confidential information—is the cornerstone of the misappropriation theory of insider trading liability, on which the SEC’s case relies. The SEC has not established that there was any deception in this case. Mr. Rorech disclosed to his supervisors on the

of state law, Bainbridge argues that the “prohibition’s location in the federal securities laws [is] a historical accident”⁷³ Consequently, he has, rather refreshingly, called for the federal courts to recognize that insider-trading law does not involve fraud at all; rather, it involves a federal common-law intellectual-property right.⁷⁴ Fully recognizing the many jurisprudential problems involved in, among other things, the creation of a de facto federal common-law crime,⁷⁵ Bainbridge argues that the current *civil* law regime may have some continuing justification because the SEC has developed a comparative advantage in detecting and prosecuting violations of such rights in the securities markets.⁷⁶

I agree with Bainbridge that the law is likely to remain hopelessly incoherent if the courts continue to justify its de facto property regime through the rhetoric of deception. I, however, diverge from him on many grounds. Most importantly, although it is often asserted that the classic and misappropriation theories of unlawful trading are complementary,⁷⁷ in fact they

sales desk and in capital markets that he was, in fact, sharing information about the potential holding company issuance with his customers, including Mr. Negrin’s hedge fund, Millennium. Mr. Rorech was never told to stop sharing such information nor cautioned as to its allegedly confidential nature.

Id. at 373 (citing *United States v. O’Hagan*, 521 U.S. 642, 652–55 (1997)).

⁷³ Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1644 (1999) [hereinafter Bainbridge, *Path Dependent*].

⁷⁴ “The Court should again explicitly acknowledge that it is making common law. The rules it announces should be based on the protection of property rights, not on inapt securities fraud concepts.” *Id.* at 1651.

⁷⁵ In Thomas Hazen’s words:

Though federal securities law is statutory in nature (and thus technically speaking has not been derived by courts as a matter of common law), the law of insider trading has an essentially common-law character. This is because the law is not spelled out with particularity in the statute or SEC rules, but rather is found in the case law. Accordingly, insider and outsider trading law has developed through courts adapting insider trading prohibitions to section 10(b)’s and Rule 10b-5’s broadly worded fraud and deception limitations, much in the same manner as common law evolves—i.e., on a case-by-case basis.

Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Non-public Information*, 61 HASTINGS L.J. 881, 889–90 (2010) [hereinafter Hazen, *Outsider Trading*]. Like me, Hazen “suggests that a statutory definition of prohibited insider and outsider trading is long overdue” because judges have had to “muddle through the tortuous path” of the case law and have resulted in “decisions [that] are confusing and inconsistent with one another.” *Id.* at 883, 887, 889.

⁷⁶ Bainbridge, *Path Dependent*, *supra* note 73, at 1591.

⁷⁷ This was Justice Ginsburg’s assertion in *O’Hagan*, 521 U.S. at 652–53.

are irreconcilable. They are based on competing views as to who owns non-public information. Moreover, the property regime reflected in the misappropriation theory is antithetical to the policy behind the securities laws.

As I have argued elsewhere,⁷⁸ the classic theory implicitly holds that certain information about publicly traded corporations belongs not merely to the issuer, but by extension, to the existing and potential shareholders of that corporation—that is, the trading public.⁷⁹ A classic insider who has fiduciary duties to the issuer cannot, therefore, deal in this “property” for personal benefit without first disclosing the information to the trading public, the imputed “owners” of the information. Because the insider does not have the right to make such a disclosure, this so-called disclose-or-abstain rule is, in fact, an abstain rule.⁸⁰ The problems with this theory are legion and well-known and shall not be rehashed again here.⁸¹ Nevertheless the classic

⁷⁸ Schroeder, *Envy*, *supra* note 12, at 2067–69.

⁷⁹ If classic insider trading law is really based on state fiduciary duty law, then it should only prohibit insiders from buying and selling equity stock from or to existing shareholders, but should not prohibit selling stock to *potential* shareholders. Nevertheless, the Supreme Court noted in *Chiarella* that “it would be a sorry distinction to allow [the insider] to use the advantage of his position to induce the buyer into the position of a beneficiary although he was forbidden to do so once the buyer had become one.” *Chiarella v. United States*, 445 U.S. 222, 227 n.8 (1980) (quoting Judge Learned Hand in *Gratz v. Claughton*, 187 F.2d 46, 49 (2d Cir. 1951), *cert. denied*, 341 U.S. 920 (1951)). I am not the first one to conclude that this illustrates the incoherence of the Supreme Court’s insider trading jurisprudence. *See, e.g.*, Nagy, *Fiduciary Principles*, *supra* note 29, at 1118.

⁸⁰ As the Court of Appeals for the Second Circuit has recently noted, “if disclosure is impracticable or prohibited by business considerations or by law, the duty is to abstain from trading.” *SEC v. Obus*, 693 F.3d 276, 285 (2d Cir. 2012) (citing *United States v. Teicher*, 987 F.2d 112, 120 (2d Cir. 1993)).

⁸¹ A few examples of problems with the classic theory, besides the issue of assuming a fiduciary duty to non-shareholders in open-market transactions, are in order. First, it is not at all clear that it is a correct interpretation of the fiduciary duties of traditional insiders, which is ordinarily considered the bailiwick of state corporate law (which is one reason why Bainbridge believes that it should be considered federal common law). *See* Bainbridge, *Fiduciary Duties*, *supra* note 9, at 1192. Second, if the problem is that the traditional insider is self-dealing, should not trading be permitted if the insider makes full disclosure of his intent to trade to the Board of Directors and obtains the consent of the disinterested directors? After all, this is the rule that applies when an insider wishes to exploit a corporate opportunity. Third, the classic theory is arguably limited to trading in equity securities, because it is black-letter law that corporations and their insiders only have fiduciary duties to shareholders and mere contract duty to debt holders. But concerns as to market integrity and efficiency would seem to be identical for the markets of debt and equity. Fourth, for almost every “innocent” shareholder who is “injured” by insider trading by, for example, buying shares at “too high” a price immediately before a drop when information is disclosed, there will always be another equally “innocent” shareholder who has benefitted by selling high. Indeed, it is not clear how the former shareholder had been injured since she intended to purchase the shares at a time when she was not yet entitled to the nonpublic information.

theory has resulted in fairly clear guidelines applicable to a limited and easily identifiable class of persons.

The misappropriation theory, in contrast, holds that the nonpublic information belongs to the source and need *not* be shared with the public.⁸² The source, as owner of the information, is free to exploit it for its own financial benefit as the source deems fit, including using it to trade in securities. In contrast, a person, who has fiduciary duties to the source, may not deal in the source's "property" for his own purposes, including trading in securities, unless he first makes disclosure of her intent to the source.

I believe that the misappropriation theory's allocation of property rights in information is at best not relevant to, and in some cases inconsistent with, the mandatory disclosure regime of the federal securities laws. As such, it should be left to the state law of trade secrets. Indeed, Bainbridge admits that his analysis "implicates all sorts of issues of institutional competence, statutory interpretation, federalism, and the like"⁸³ Moreover, even if the courts were to adopt a federal common law protecting proprietary interests in information, there is no justification for limiting this protection to its use in the purchase and sale of securities, as opposed to all self-dealing.

In any event, the wisdom of the current insider trading regime with respect to non-congressional actors is beyond the scope of this Article. There seems to be widespread revulsion among the public over the idea of "insider" trading, despite an inchoate conception as to what the phrase might mean.⁸⁴ Consequently, it is highly unlikely that Congress, the SEC, or the courts would significantly change the law to permit more insider trading merely because of criticism by academics like myself. As I shall discuss later, however, this property analysis will bring into question whether the STOCK Act will effectively restrict congressional trading.⁸⁵ Arguably, this shows the inadequacy of the property analysis and demonstrates yet another reason why Congress should amend the securities laws to add a definition aimed directly at the goals that restrictions on insider trading are supposed to accomplish, whether conceived in terms of fairness, efficiency, market integrity, or something else.

A final problem is more directly related to this Article, namely that the classic theory does not implicate a lot of trading that the public finds equally problematic—such as trading in securities of a potential target based on nonpublic information obtained from a potential bidder. This, of course, is the situation in *O'Hagan*, in which the Supreme Court adopted the misappropriation theory. See *United States v. O'Hagan*, 521 U.S. at 642–43.

⁸² I set forth this argument in full in Schroeder, *Envy*, *supra* note 12, at 2073–75.

⁸³ See Bainbridge, *Path Dependent*, *supra* note 73, at 1650.

⁸⁴ See Hazen, *Outsider Trading*, *supra* note 75, at 883–84.

⁸⁵ See *infra* notes 128, 286 and accompanying text.

C. *The Law of Insider Trading*

1. *Fraud*

To reiterate, because there is no statutory or regulatory definition other than in the context of a tender offer,⁸⁶ the purchase and sale of securities on the basis of material nonpublic information can only be unlawful if it falls within the '34 Act's catchall prohibition of section 10(b), which proscribes "in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention" of the rules of the SEC.⁸⁷ The SEC has adopted several rules under this provision, most importantly Rule 10b-5, which reads in relevant part:

It shall be unlawful for any person, directly or indirectly [to use the jurisdictional means]:

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, 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.⁸⁸

For the past 35 years—since its opinion in *Santa Fe Industries, Inc. v. Green*⁸⁹—the Supreme Court has emphasized that section 10(b) encompasses only actual, not constructive, fraud, and that fraud requires deception.⁹⁰ Consequently, in its three insider-trading cases, the Court has reiterated that Rule 10b-5, promulgated under section 10(b), can prohibit only deceitful activities.⁹¹

⁸⁶ As mentioned in passing, Rule 14e-3 is a broad rule prohibiting trading by certain persons on the basis of material nonpublic information after someone has taken significant steps towards the commencement of a tender offer. *See supra* note 33 and accompanying text. As its numeration indicates, this Rule was not promulgated under section 10(b) of the '34 Act, but under section 14(e)(3), which gives the SEC the authority to "prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative...." 15 U.S.C.A. § 78o(c)(2)(D) (West 2013). In *O'Hagan*, the majority of the Supreme Court found that this broad language of 14(e) gave the SEC powers to adopt prophylactic rules in connection with tender offers. *See United States v. O'Hagan*, 521 U.S. 642, 666–77 (1997).

⁸⁷ 15 U.S.C.A. § 78j(b) (West 2013).

⁸⁸ 17 C.F.R. § 240.10b-5 (2014).

⁸⁹ *Santa Fe Indus. v. Green*, 430 U.S. 462, 478–80 (1977).

⁹⁰ 521 U.S. at 651–52.

⁹¹ "Liability under Rule 10b-5, our precedent indicates, does not extend beyond conduct encompassed by § 10(b)'s prohibition." *Id.* at 651. "Section 10 (b) is aptly described as a

This creates at least two major problems in applying section 10(b) to insider trading. First, as already discussed, those who wish to prohibit some form of insider trading want to do so not because they believe it is fraudulent. Consequently, there is an inevitable disconnect between judicial interpretation of what the law in fact bans and what the public (and the SEC) would like it to ban. Second, in what way could trading on the basis of material, non-public information be *fraudulent*? Fraud is a complex intentional tort of many elements. What interests us at this stage is that to allege fraud, it is not enough that the defendant cheated or treated someone unfairly.

2. *The Duty to Speak*

Fraud requires, among other things, that the fraudster *lied* to someone.⁹² This concept is relatively straightforward when someone makes an affirmative misstatement to a victim. It becomes more difficult when he is silent, as in the case of insider trading. That is, to state the obvious, insider (and outsider) trading concerns the trading of securities by a person having information that he has not disclosed to the trading public. When does silence become fraudulent speech?

It is black-letter law that absent a legal duty to speak, silence is not fraudulent.⁹³ It is also black-letter law that the securities laws do not mandate parity of information, so mere possession of material information in and of itself does not give a person a duty to speak.⁹⁴

There are, of course, legal exceptions to “silence is golden.” For example, the securities laws give issuers of publicly traded securities some very specific duties to speak at specific times—such as the requirement that they file annual reports on Form 10-K within a certain number of days after the end of their fiscal years.⁹⁵ Insider trading occurs, however, at a time when there is no such clear statutory duty under the securities laws.

The final question we shall consider is that section 10(b) and Rule 10b-5 are not a sweeping federal law of fraud generally, but of only fraud “in

catchall provision, but what it catches must be fraud.” *Chiarella v. United States*, 445 U.S. 222, 234–35 (1980).

⁹² Other elements of securities fraud include the fraudster acted with scienter, the lie concerned a material fact, and the fraud caused harm to the plaintiff. The element of reliance is necessary as part of a showing of “transaction” causation (roughly equivalent to but-for causation). In addition, the plaintiff must show “loss” causation, which is roughly equivalent to proximate causation. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 157, 165–68, 171 (2008).

⁹³ 15 U.S.C.A. § 78j (West 2013).

⁹⁴ *Id.* See also *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 610 F. Supp. 2d 600, 619, 625 (S.D. Tex. 2009).

⁹⁵ 15 U.S.C.A. §§ 78m, 78o(d) (West 2013).

connection with the purchase or sale of any security.”⁹⁶ To understand why this is problematic, we must first explain the two different theories of insider trading.

The duty to speak under both theories seems to be based on the so-called special-facts doctrine, imported from fiduciary duty law. Sometimes a trustee has an affirmative duty to make disclosures to her beneficiaries prior to dealing with the corpus of the trust for the trustee’s own behalf. As both Bainbridge and I have argued, the special-facts doctrine, in fact, has less to do with fraud than with self-dealing—an agent’s unauthorized use of her principal’s property.⁹⁷

I say that the theories “seem to be based” on this doctrine because the courts are remarkably reticent in explaining their underlying theories. Once again, I, among others, have told this story extensively elsewhere, so I will only give a brief rundown of those issues directly relevant to my analysis.⁹⁸

a. Classic Insider Trading

Because the STOCK Act implicitly invokes the misappropriation theory, I will only mention the classic theory in passing. Classic insider trading occurs when a traditional insider of a publicly traded company—such as an officer, director, employee, or controlling shareholder—purchases or sells the equity securities of that company on the basis of material nonpublic, and firm-specific information about that company obtained through her position with the company. Although the courts rarely state their reasoning expressly, the intuition seems to be that under state law: (i) a traditional insider owes a fiduciary duty of loyalty to her corporation and, indirectly, its shareholders, (ii) a fiduciary may not deal in the property of her beneficiary for her open personal benefit, and (iii) material nonpublic information about that corporation can be thought of as corporate property; and, therefore, the insider has a duty to speak to the shareholders before using this information on her own behalf. This is the so-called disclose-or-abstain rule.⁹⁹

⁹⁶ 17 C.F.R. § 240.10b-5 (2014).

⁹⁷ I have compared the classic theory of insider trading to the rule that insiders of a corporation may not take a “corporate opportunity” for personal gain. Schroeder, *Envy*, *supra* note 12, at 2053, 2070.

⁹⁸ See Hazen, *Outsider Trading*, *supra* note 75.

⁹⁹ *Chiarella v. United States*, 445 U.S. 222, 226–28 (1980). In fact, the Supreme Court’s characterization of state law does not seem accurate. For example, while an officer or director of a corporation may have a fiduciary duty to its shareholders, a mere employee would only have a duty to the corporation itself. Moreover, under state law, management’s fiduciary duty would only run to current, but not potential, shareholders, suggesting that only purchases, but not sales, of securities should run afoul of the law. *See supra* note 81

This rule has been extended to so-called temporary insiders as well. These are people who, although not traditional insiders, such as officers of the company, nevertheless have a fiduciary-type duty of confidentiality to the issuer. The most obvious example would be the company's outside counsel, who has a duty of confidentiality by virtue of the code of professional responsibility.¹⁰⁰ I shall not discuss here what other relationships create such a duty because this issue has largely been subsumed under the misappropriation theory as a practical matter.

b. Misappropriation

Because the classic theory, as set forth in *Chiarella* and *Dirks*, does not cover many transactions that seem intuitively to be equally unseemly, the SEC and DOJ sought to develop an alternate theory of unlawful trading.¹⁰¹ In *United States v. Carpenter*, the Second Circuit adopted what has come to be called the misappropriation theory.¹⁰² On appeal, the Supreme Court upheld the misappropriation theory as a basis for a wire fraud prosecution, but split 4–4 on whether it could also form the basis for a securities fraud prosecution.¹⁰³ Consequently, although the Second Circuit's decision upholding the conviction for securities fraud stood, the law remained unclear nationally for another decade until *United States v. O'Hagan* in 1997.¹⁰⁴

The facts of *O'Hagan* on first blush seem to illustrate precisely why a new theory was necessary. The Supreme Court's analysis, however, is unfortunate. It is not based on the securities law principle of public disclosure, but on the antithetical intellectual property law principles of exclusivity and secrecy. It supports convicting a defendant of securities fraud even when there is no victim of securities fraud.¹⁰⁵ It is also amorphous, lacking clear boundaries. Unfortunately, the language of the STOCK Act tracks the SEC's attempt to broaden the rule of *O'Hagan*. As such, it is still not clear how to apply it to congressional trading.

and *infra* note 100. Finally, the duty to speak would run to the corporation and not directly to the shareholders. 445 U.S. at 222–23.

¹⁰⁰ “The classical theory applies not only to officers, directors, and other permanent insiders of a corporation, but also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation.” *United States v. O'Hagan*, 521 U.S. 642, 652 (1997); Schroeder, *Envy*, *supra* note 12, at 2056–57.

¹⁰¹ The SEC adopted Rule 14e-3 to deal with the specific fact pattern in *Chiarella*, namely trading by a non-insider in securities of an entity involved in a tender offer. *See* 17 C.F.R. § 240.14e-3 (2014); 455 U.S. at 222–23.

¹⁰² *United States v. Carpenter*, 791 F.2d 1024, 1026–29 (2d Cir. 1986).

¹⁰³ *Carpenter v. United States*, 484 U.S. 19 (1987).

¹⁰⁴ 521 U.S. at 676–78 (1997).

¹⁰⁵ *See supra* note 101 and accompanying text.

James O'Hagan, a partner in a law firm, learned that one of its clients, Grand Met, intended to launch a hostile takeover of Pillsbury. Based on this information, he bought call options in the target and made a quick \$4.3 million profit.¹⁰⁶ (If this unethical behavior by an attorney is not appalling enough, the reason why he needed the money was to surreptitiously pay back money he embezzled as a trustee for another client.¹⁰⁷) Even though O'Hagan clearly purchased and sold securities on the basis of material nonpublic information, he could not be prosecuted under the classic theory because the source of the information was not the issuer of the securities traded. That is, with respect to Pillsbury, O'Hagan was an outsider, not an insider.

Someone who is not a securities lawyer might be shocked that we could not prosecute O'Hagan for insider trading and demand that the law be changed. The lawyer's reply, however, is that of course we could do so prior to *O'Hagan*—but not under Rule 10b-5. He was clearly in violation of Rule 14e-3—which was promulgated to overrule *Chiarella*—because a substantial step had been taken by his client towards the commencement of a tender offer. In *O'Hagan* the majority of the Supreme Court affirmed that unlike section 10(b), which is limited to actual fraud, the broad language of 14(e) gives the SEC authority to promulgate prophylactic rules with respect to tender offers.¹⁰⁸ Consequently, by indicting O'Hagan under Rule 10b-5 in addition to Rule 14e-3, the DOJ was trying to increase his punishment.

In *Carpenter*, the Supreme Court held that a violation of a fiduciary-type duty of confidentiality can constitute fraud for the purposes of the federal wire fraud statute, which prohibits the “obtaining [of] money or property by means of false or fraudulent pretenses, representations, or promises, transmits or causes to be transmitted by means of wire, radio, or television communication”¹⁰⁹ The theory is that when one enters into a fiduciary-type relationship of confidentiality with a person, one makes an implied (or often express) representation that one will keep the confidence and will not use the information for one's own benefit. If one, in fact, intends to do so, one is lying through silence. That is, once one is deemed to have made this implied representation, one acquires an affirmative duty to speak and inform the source of one's intention to break the confidence. Omitting to speak can be a fraud. Finally, the Supreme Court held that confidential information is property.¹¹⁰ This means that when a disloyal confidant uses confidential

¹⁰⁶ 521 U.S. at 647–48.

¹⁰⁷ Richard D. Hylton, *S.E.C. Cites Lawyer Over Grand Met*, N.Y. TIMES (Jan. 11, 1990), <http://www.nytimes.com/1990/01/11/business/sec-cites-lawyer-over-grand-met.html>.

¹⁰⁸ 521 U.S. at 666–78.

¹⁰⁹ 18 U.S.C.A. § 1343 (West 2013).

¹¹⁰ *Carpenter v. United States*, 484 U.S. 19, 24–25, 28–29 (1987).

information for his own benefit, without first disclosing this to the source, he is misappropriating property of the source through fraud. It is analogous to embezzlement.¹¹¹ If the jurisdictional means are met, this can be a violation of federal law.

This misappropriation rule is problematic in the context of wire fraud if for no other reason that it is very unclear under state law whether trade secrets should be analyzed as property, or whether violation of confidentiality agreements should instead be deemed a breach of contract, a tort, or a *sui generis* harm.¹¹² This is one of the reasons, no doubt, why Bainbridge argues that these cases should be read as a new *federal* common law of trade secrets.¹¹³

II. THE LIMITS OF THE MISAPPROPRIATION THEORY

A. *The Missing Loophole*

The STOCK Act was supposedly needed in order to close a loophole for members of Congress and their staffers.¹¹⁴ In fact, there never was such a loophole.

Two things were absolutely clear, even before the STOCK Act was enacted. If a senator or representative was *also* a classic insider—that is, an officer, director, employee, or major shareholder—of a publicly traded company, he was subject to the same restrictions on trading stock *of that company* on the basis of material, nonpublic information *obtained from that company* as any other classic insider. Similarly, if a senator or representative was a classic insider of an issuer, and disclosed material, nonpublic information about that issuer to another person, such as a family member or donor, both the Congress member and that person would be subject to the same complex case law applicable to classic tippers and tippees.

Second, if a senator or representative was the one being tipped off about material, nonpublic information relevant to a public corporation by someone who was either a classic insider or a misappropriator, the same rules would apply to her as to any other tippee.¹¹⁵ Indeed, an intentional tip might not only

¹¹¹ Which is how Justice Ginsburg characterized the holding of *Carpenter*. See 521 U.S. at 654.

¹¹² Schroeder, *Unnatural Rights*, *supra* note 38.

¹¹³ See *supra* note 81 and accompanying text.

¹¹⁴ For example, Donna Nagy cites an influential *Wall Street Journal* article, which asserted that “Congress is immune from insider-trading laws.” Nagy, *Entrustment supra* note 2, at 1106 (quoting Tom McGinty & Brody Mullins, *Lawmaker Vows to Outlaw Insider Trading on the Hill*, WALL ST. J. (Oct. 12, 2010, 12:01 AM), <http://online.wsj.com/article/SB10001424052748704518104575546543960520172.html>).

¹¹⁵ Not all trading by tippees is unlawful. The Supreme Court set forth the conditions for unlawful tipping in *Dirks v. SEC*, 463 U.S. 646, 655–63 (1983). Subsequently, some lower courts have suggested that *Dirks* only sets deals with unlawful trading under the classic

violate the securities laws, but could conceivably implicate ethical rules and anti-corruption laws as well.¹¹⁶

For example, although he was never formally charged, William Frist, then Senate Majority Leader, was criticized when he sold stock of Hospital Corporation of America, a company founded and dominated by his family, shortly before its stock price took a plunge.¹¹⁷ It was suspected that he was trading on nonpublic information about the company that he received either as an insider by virtue of his stock ownership or as a tippee of a family member, who was an insider.

The STOCK Act is intended not to define classic insider trading, but to clarify whether or when the alternative misappropriation theory of outsider trading applies to senators, representatives, and their staffers, who obtain material, nonpublic information from their positions. Misappropriation involves the purchase or sale of securities on the basis of material, nonpublic information received from a source *other than the issuer* of those securities. It was not clear if, or when, for example, it would be illegal for a senator to purchase stock in a company that he knew would benefit from some upcoming, unpublicized legislation.¹¹⁸ Unfortunately, it is still not clear.

In *O'Hagan*, the Supreme Court extended the misappropriation theory of wire fraud to securities fraud. It held that because O'Hagan received information about his ex-client's tender offer plans in a relationship of confidentiality arising from his professional responsibility as an attorney, he had a duty to speak if he intended to breach this confidence.¹¹⁹ Thus, silence can constitute a fraud. This is a fraud "in connection with the purchase and sale of securities,"¹²⁰ because the fraud was "consummated"¹²¹ when he traded

theory, and may not apply in its entirety to tips under the misappropriation theory. *See, e.g.,* United States v. Falcone, 257 F.3d 226, 228–31 (2d Cir. 2001). This debate is beyond the scope of this Article.

¹¹⁶ Whether or under what conditions it would be beyond the scope of this Article.

¹¹⁷ David D. Kirkpatrick, *Senate Leader Explains His Sale of a Stock that then Plummeted*, N.Y. TIMES (Sept. 22, 2005), http://www.nytimes.com/2005/09/22/politics/22_frist.html.

¹¹⁸ The STOCK Act as originally proposed was also supposed to clarify the law of the use of so-called political information. This is information about pending legislation gathered by lobbyists and consultants for the purpose of selling to their investor clients. These provisions were deleted from the final Act, which merely directs that the Comptroller General of the United States, in consultation with the Congressional Research Service, deliver a report on political information to the Committee on Homeland Security and Governmental Affairs of the Senate and the Committee on Oversight and Government Reform and the Committee on the Judiciary of the House of Representatives. Stop Trading on Congressional Knowledge Act of 2012 (STOCK Act), Pub. L. No. 112-105, § 7, 126 Stat. 291, 294–95 (2012). Political information is beyond the scope of this Article.

¹¹⁹ United States v. O'Hagan, 521 U.S. 642, 642 (1997).

¹²⁰ *Id.* at 653.

¹²¹ *Id.* at 656.

in Pillsbury securities on the basis of the information. The *O'Hagan* opinion raises a few anomalies that are not directly related to this Article—including the fact that it contemplates liability for securities fraud where there is no *victim*—neither the source nor the investment public—of securities law.¹²² It also leaves unanswered some perennial questions relevant to both classic and misappropriation insider trading, such as whether it is sufficient if a defendant trades when in knowing possession of nonpublic information, or whether there must be some causal relationship between the information and the trade.¹²³ I will discuss only those issues that I think raise the biggest questions for its application of the misappropriation theory to trading by governmental actors.

B. The Fiduciary or “Equivalent” Duty Element

To recap, the conundrum of the misappropriation theory arises because the Supreme Court insists that insider–outsider trading is only unlawful under Rule 10b-5 if it is deceptive. Insider–outsider trading law involves omissions rather than affirmative misstatements of fact, and omissions can only form the basis of deception if there is a duty to speak. The mere possession of nonpublic information never imposes a duty to speak by itself.¹²⁴ The Supreme Court has found a duty to speak under certain circumstances under a questionable reading of the special-facts doctrine derived from the common law of agency. This raises the question of precisely what relationship a confidant must have to the source of nonpublic information to invoke the special-facts doctrine for the purposes of misappropriation liability?

¹²² See *id.* at 642. The “defrauded” sources of confidential information—Grand Met and O’Hagan’s law firm—may or may not have a state-law claim for breach of fiduciary duty, violation of trade-secret law, or legal malpractice. *Id.* at 655, 659 n.9. However, the source cannot sue the confidant under Rule 10b-5. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), established that only someone who actually purchases or sells securities can sue for securities fraud. *Id.* at 753–55. Investors who purchased or sold securities may or may not have a statutory cause of action under section 20A of the ’34 Act as contemporaneous traders, but cannot sue for securities fraud since the trader, by definition, owed no duty to speak to the public. See *supra* notes 115–118 and accompanying text.

¹²³ See generally, Donna M. Nagy, *The “Possession vs. Use” Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never be Golden*, 67 U. CIN. L. REV. 1129 (1999). This issue is beyond the scope of this Article.

¹²⁴ “A misappropriator who trades on the basis of material, nonpublic information, in short, gains his advantageous market position through deception; he deceives the source of the information and simultaneously harms members of the investing public.” 521 U.S. at 656. “Liability under Rule 10b-5, our precedent indicates, does not extend beyond conduct encompassed by § 10(b)’s prohibition.” *Id.* at 651 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976); *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 173 (1994)).

All three Supreme Court insider trading cases—*Chiarella*, *Dirks*, and *O’Hagan*—usually, but not always, describe the requisite relationship as “fiduciary.”¹²⁵ However, the Supreme Court’s formulations can be read as not necessarily limiting fiduciary-type duties to traditional status relationships, suggesting that the requisite duties might be established by contract.¹²⁶

¹²⁵ At several points in *O’Hagan*, Justice Ginsburg describes the deception required for misappropriation in terms of a violation of a duty of “trust and confidence.” See, e.g., 521 U.S. at 643, 645, 652. She otherwise narrows this to “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.” 521 U.S. at 652 (emphasis added); see also *id.* (“[T]he misappropriation theory premises liability on a fiduciary-turned-trader’s deception of those who entrusted him with access to confidential information.”). Justice Thomas, in his dissent, agrees with Ginsburg’s characterization that misappropriation involves a breach of a fiduciary duty. *Id.* at 680–81 (Thomas, J., dissenting) (“I do not take issue with the majority’s determination that the undisclosed misappropriation of confidential information by a fiduciary can constitute a ‘deceptive device’....”). Elsewhere, Ginsburg quotes the government’s brief with approval, which describes the theory as being based on the “common law rule that a trustee may not use the property that [has] been entrusted [to] him.” *Id.* at 654. Moreover, the two examples she gives of persons who have the type of duties necessary for insider-trading liability are traditional fiduciaries—i.e., officers and directors of corporations under the classic theory, and *O’Hagan* himself who, as an attorney has a fiduciary duty to his firm and client. *Id.* at 644.

Similarly in *Carpenter*, in which the Supreme Court upheld the misappropriation theory in the context of wire fraud, Justice White, applying New York law, found that R. Foster Winans violated his *fiduciary* duty to his employer—*The Wall Street Journal*—when he used its confidential, proprietary information for his own purposes, without disclosing this intention. Justice White stated:

[in an earlier case] we noted the similar prohibitions of the common law, that “even in the absence of a written contract, an employee has a *fiduciary* obligation to protect confidential information obtained during the course of his employment.” As the New York courts have recognized: “It is well established, as a general proposition, that a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his own personal benefit but must account to his principal for any profits derived therefrom.”

Carpenter v. United States, 484 U.S. 19, 27–28 (1987) (emphasis added) (citing *Diamond v. Oreamuno*, 248 N.E.2d 910, 912 (1969); RESTATEMENT (SECOND) OF AGENCY §§ 388 cmt. c, 396(c) (1958)).

¹²⁶ In *Chiarella*, the Supreme Court’s earliest insider-trading case, Justice Powell stated that *Chiarella*, the “employee of [a] financial printer which had been engaged to print corporate take-over bids,” was not subject to limitations on trading because he “was not [the source’s] agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.” *Chiarella v. United States*, 445 U.S. 222, 222, 232–33 (1980). In *Dirks*, Justice Powell, once again speaking for the Court, rejected the SEC’s argument that mere possession of material nonpublic information subjected the defendant to the disclose or abstain rule:

It is undisputed that [the defendant] himself was a stranger to [the source], with no pre-existing fiduciary duty to its shareholders. He took no action,

Donna Nagy suggests that some lower courts and the SEC have extended the *O'Hagan* duty-to-speak to so many circumstances that it is no longer clear whether, as a practical matter, it is still limited to the *fiduciary-type* duty invoked by the Supreme Court or even its *functional equivalent* as permitted by the Second Circuit.¹²⁷ I think that this goes too far. Nevertheless, I agree that it is questionable whether the mere duties of “trust or confidence” reflected in the SEC’s rules, or “trust *and* confidence” adopted by *some* courts, are consistent with the Supreme Court precedents. This is why I shall suggest¹²⁸ that Congress’s decision to include the duty-of-trust-and-confidence formulation in the STOCK Act might serve as an implicit endorsement of this less rigorous standard in litigation against non-congressional actors. Because Nagy does such a thorough job explicating the case law (and settled litigation), I will not attempt to replicate this history, but only raise a few points as illustration in anticipation of my analysis of the STOCK Act.

directly or indirectly, that induced the shareholders or officers of [the source] to repose trust or confidence in him. There was no expectation by [the defendant’s] sources that he would keep their information in confidence. Nor did [the defendant] misappropriate or illegally obtain the information about [the source].

Dirks v. SEC, 463 U.S. 646, 665 (1983) (citations omitted).

Both these passages could be read to imply by negative pregnant that the necessary relationship might be merely one of “trust and confidence,” rather than the higher fiduciary standard, and that it might be established by contractual or other means.

In the language from *Carpenter* just quoted, Justice White can be read as suggesting that it might also be able to establish the requisite duty of confidentiality by a written contract. But it is significant that the case did not involve just any type of contract, but specifically an *employment* contract. Justice White repeatedly invoked the *Wall Street Journal’s* company policy against trading embodied in its employee manual—which might suggest, on the one hand that the duty of confidentiality was established by Winan’s employment contract. 484 U.S. at 23, 28. However, he emphasized that “even in the absence of a written contract, an employee has a *fiduciary* obligation to protect confidential information obtained during the course of his employment.” 484 U.S. at 27 (emphasis added) (quoting *Snepp v. United States*, 444 U.S. 507, 515 n.11 (1980) (*per curiam*)). Under basic principles of principal-agency law, employees, as agents of their employers within the scope of their employment, have the fiduciary duties not to use their position for their own profit, not to use their principal’s property for their personal purposes, and not to reveal their principal’s confidential information. RESTATEMENT (THIRD) OF AGENCY §§ 8.02, 8.05. Moreover, Winans might be subject to higher duties than ordinary employees having access to trade secrets and other confidential information, because of ethical duties recognized in the journalism profession.

¹²⁷ She notes that “[o]n some occasions, judicial adherence to fiduciary principles would have dictated rulings in favor of defendants charged with insider trading, but courts essentially ignored those principles. SEC settlements in insider trading cases also reflect this disregard.” Nagy, *Fiduciary Principles*, *supra* note 29, at 1319 (citations omitted).

¹²⁸ See *infra* Part III.B.2.

1. *Familial Relationships*

Probably the most well-known formulation of the requisite duty required under the misappropriation theory is contained in the Second Circuit's pre-*O'Hagan* opinion of *Chestman*. Famously, it found the government did not establish the necessary duty of confidence under either the classic or misappropriation theory merely by showing that the source and the confidant were married: "marriage does not, without more, create a fiduciary relationship."¹²⁹

In so concluding, the Second Circuit noted that some relationships are "inherently fiduciary," the classic examples being "attorney and client, executor and heir, guardian and ward, principal and agent, trustee and trust beneficiary, and senior corporate official and shareholder."¹³⁰ After a review of the case law, it concluded that the common denominator of these diverse relationships was that they all "involve[] discretionary authority and dependency: One person depends on another—the fiduciary—to serve his interests."¹³¹

The Second Circuit was particularly worried about the implications if the concept of a fiduciary duty or *functional equivalent* were interpreted broadly under the misappropriation theory.¹³² A broad interpretation would "lose method and predictability, taking over 'the whole corporate universe.'"¹³³

¹²⁹ *United States v. Chestman*, 947 F.2d 551, 568 (2d Cir. 1991).

¹³⁰ *Id.*

¹³¹ *Id.* at 569. The court continued:

In relying on a fiduciary to act for his benefit, the beneficiary of the relation may entrust the fiduciary with custody over property of one sort or another. Because the fiduciary obtains access to this property to serve the ends of the fiduciary relationship, he becomes duty-bound not to appropriate the property for his own use.

Id. The court was not about to find that an educated woman in a modern, companionable marriage was so dependent on her husband as to make him her fiduciary.

¹³² It stated:

This is because a fraud-on-the-source theory of liability extends the focus of Rule 10b-5 beyond the confined sphere of fiduciary/shareholder relations to fiduciary breaches of any sort, a particularly broad expansion of 10b-5 liability if the add-on, a "similar relationship of trust and confidence," is construed liberally. One concern triggered by this broadened inquiry is that fiduciary duties are circumscribed with some clarity in the context of shareholder relations but lack definition in other contexts.

Id. at 567.

¹³³ *Id.* at 567 (citing its earlier opinion in *United States v. Chiarella*, 588 F.2d 1358, 1377 (2d Cir. 1978) (Meskill, J., dissenting) (quoting *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 480 (1977)) *rev'd*, 445 U.S. 222 (1980)). It continued:

As the term "similar" implies, a "relationship of trust and confidence" must share the essential characteristics of a fiduciary association. Absent reference to the adjective "similar," interpretation of a "relationship of trust and confidence" becomes an exercise in question begging. Consider: when one *entrusts* a secret (read *confidence*) to another, there then exists

Although the Second Circuit's formulation seems to encompass fiduciary duties established by status, it does not necessarily exclude duties established by contractual principles.¹³⁴ Perhaps more importantly, the Second Circuit referred to fiduciary duties "and their functional equivalent."¹³⁵ Finally, the court did not rule out that family members could establish such a duty through a course of conduct.¹³⁶ The court, however, expressed a concern that an "elastic" definition of the requisite duty, while perhaps permissible in the civil context, would be inappropriate in a criminal litigation.¹³⁷

The law has not become clearer since. *Chestman* is, obviously, the law of the Second Circuit. But, despite its influence, various courts have held that either *Chestman* does not apply in their jurisdiction, or have found that the specific facts of a case have established fiduciary or equivalent duties between family members.¹³⁸

a relationship of trust and confidence. *Walton*, however, instructs that entrusting confidential information to another does not, without more, create the necessary relationship and its correlative duty to maintain the confidence. A "similar relationship of trust and confidence," therefore, must be the functional equivalent of a fiduciary relationship.

Id. at 568.

¹³⁴ For example, in the subsequent pre-*O'Hagan* case of *United States v. Libera*, 989 F.2d 596 (2d Cir. 1993), the same court found that defendants who tipped pre-publication information contained in unreleased *Business Week* articles had violated their duties to their employers, the printer and publisher of the magazine. *Id.* at 601–02. In doing so, however, the Second Circuit did not refer to the test of what constitutes a fiduciary relationship set forth in *Chestman*. It referred to the companies' confidentiality policies communicated in employee orientation, company handbooks and posters, as well as the posting of guards to prevent employees from removing pre-release copies of the magazine from the premises. On the one hand, this might suggest that the duty can be established through contract. On the other, this might suggest that it is limited to *employment* relationships, which are traditionally fiduciary in nature under basic principles of agency.

¹³⁵ 947 F.2d at 567.

¹³⁶ *Id.*

¹³⁷ *Id.* at 570. For example, it noted that in the earlier case of *United States v. Reed*, 601 F. Supp. 685, 685 (S.D.N.Y. 1985), *rev'd on other grounds*, 773 F.2d 477, 477 (2d Cir.), the District Court for the Southern District of New York found "the repeated disclosure of business secrets between family members may substitute for a factual finding of dependence and influence and thereby sustain a finding of the functional equivalent of a fiduciary relationship." 947 F.2d at 569 (addressing, in this case, a father-son relationship).

¹³⁸ To give a non-exclusive list of examples, the Eleventh Circuit, in *SEC v. Yun*, 327 F.3d 1263 (11th Cir. 2003), rejected the *Chestman* majority's analysis and adopted the minority's urging that often, as in this case, a relationship of trust and confidence normally exists between spouses. *Id.* at 1271. In a footnote, the court noted that

[t]he SEC's complaint used the words "duty of trust and confidence" to describe [the wife's] fiduciary duty to [her husband]—that she would not share the confidential information he gave her about [the source's] revised

2. Contractual Relations

Employees, as agents, have fiduciary duties to their employers under common law principles. Family relationships are uniquely intimate, whether or not fiduciary, and are probably *sui generis*. The more important and more controversial issue is what other relationships can impose liability for insider trading under the misappropriation theory. Although there seems to be a broad consensus that some contractually created duties may be sufficient to impose liability under the misappropriation theory, there is disagreement as to precisely what is required.¹³⁹

For example, in *SEC v. Cuban*, Judge Sidney Fitzwater of the Northern District of Texas, while agreeing that the appropriate duty could be created by contract, granted the defendant's motion¹⁴⁰ on the grounds that, as the Fifth Circuit explained, "at most, the complaint alleged an agreement to keep the information confidential, but did not include an agreement not to trade."¹⁴¹

earnings forecast with anyone (except her attorney). In this opinion, we treat the quoted words and the term "fiduciary duty" as synonymous. *Id.* at 1270 n.16.

In another case considering the nature of the relationship between spouses, *SEC v. Goodson*, No. 1:99-cv-2133-MHS, 2001 U.S. Dist. LEXIS 26493 (N.D. Ga. Mar. 6, 2001), the District Court for the Northern District of Georgia refused the defendant's motion to dismiss based on the *Chestman* analysis on the grounds that the question of spousal duties is a matter of Georgia state law. *Id.* at *6–9. In *United States v. Corbin*, 729 F. Supp. 2d 607 (S.D.N.Y. 2010), the District Court for the Southern District of New York refused the defendant's motion to dismiss of an indictment because it found that the government had adequately alleged the existence of a spousal fiduciary duty on two grounds. First, without specifying whether it was intended a statement of state or federal law, the government alleged that it would show that, under the *Chestman* rule, such a duty "arose out of their express agreement and their history, pattern, and practice of sharing and maintaining business confidences in the course of their spousal relationship..." *Id.* at 610.

Finally, in *SEC v. Yang*, No. 12 C 2473, 2013 U.S. Dist. LEXIS 162157 (N.D. Ill. Nov. 14, 2013), Judge Matthew Kennelly, in rejecting the defendant's motion for summary judgment, found that the SEC had sufficiently alleged evidence that a cohabitating boyfriend had the requisite duty to his partner to support a misappropriation charge because the two had "a history, pattern, or practice of sharing confidences" within the meaning of Rule 10b5-2. *Id.* at *24. The judge noted in particular that the partner's "casual disclosure to [the defendant] of her login name and password, which provided access to her trading history, is perhaps the best evidence of the trust and confidence she shared with him." *Id.* Moreover, the facts that the defendant "refrained from telling" his partner of his intent and that she testified that she was "shocked ... that he had used information about her trading for [another defendant] to make personal trades" was evidence that the defendant "realized that he had misappropriated information" and therefore, had scienter. *Id.* at *24–25.

¹³⁹ See generally 729 F. Supp. 2d 607, 613–19 (S.D.N.Y. 2010).

¹⁴⁰ *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009).

¹⁴¹ *SEC v. Cuban*, 620 F.3d 551, 552 (5th Cir. 2010).

In this case, flamboyant technology mogul and basketball team owner, Mark Cuban,

agreed to maintain the confidentiality of material, nonpublic information concerning a planned private investment in public equity (“PIPE”) offering by [a publicly traded issuer in which he was a significant investor. The SEC alleged that he engaged in insider trading when] he sold his stock in the company without first disclosing to [the issuer] that he intended to trade on this information, thereby avoiding substantial losses when the stock price declined after the PIPE was publicly announced.¹⁴²

Jonathan Macey notes that the court’s “point that a promise to keep information confidential is not the same as a promise to refrain from trading” is “rather obvious.”¹⁴³ In order to give rise to a legal duty to refrain from trading, a shareholder must have a “legal duty to refrain from trading on or otherwise using the information for personal gain.”¹⁴⁴ Although the Fifth Circuit reversed and remanded the lower court opinion, it did so on other grounds. In doing so, however, it noted that:

[g]iven the paucity of jurisprudence on the question of what constitutes a relationship of “trust and confidence” and the inherently fact-bound nature of determining whether such a duty exists, we decline to first determine or place our thumb on the scale in the district court’s determination of its presence or to now draw the contours of any liability that it might bring....¹⁴⁵

Upon remand, Judge Fitzwater rejected Cuban’s motion for summary judgment on the grounds that “[d]espite the closeness of this question, there is evidence ... that would enable a reasonable jury to find that Cuban

¹⁴² *Id.* For the definition of a PIPES offering, see *infra* note 269.

¹⁴³ Macey, *supra* note 9, at 661. As Starkey DeSoto points out, the facts of the case seem particularly unfair. Mark Cuban was invited to “participate in the PIPE offering because he was the largest known individual shareholder of the company. After contacting Cuban to invite him to participate, Cuban became upset and angry. Cuban explained to the CEO ‘that he did not like PIPE offerings because they dilute the existing shareholders.’” (citations omitted). Starkey DeSoto, “*Well, Now I’m Screwed*”; *The Ever-Expanding Liability for Outsider Trading*, 33 WHITTIER L. REV. 275, 298–99 (2012). Cuban became angry, famously blurting out: “Well, now I’m screwed. I can’t sell.” 634 F. Supp. 2d at 717 (quoting Complaint ¶ 14, SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. July 17, 2009) (No. 3-08CV2050-D)). That is, arguably management of the issuer was trying to shake Cuban down. If he did not spend good money after bad and participate in the PIPES offering he would lose even more by being diluted. This would be exacerbated if the confidentiality agreement were interpreted as preventing him from cutting his losses by selling.

¹⁴⁴ 634 F. Supp. 2d at 725.

¹⁴⁵ 620 F.3d 551, 558 (5th Cir. 2010).

agreed at least implicitly not to trade on the PIPE information.”¹⁴⁶ Nevertheless, the judge specifically noted that:

the Fifth Circuit did not disturb this court’s analysis of the law of the misappropriation theory of insider trading, [but] vacated and remanded based on the court’s erroneous evaluation of the sufficiency of the SEC’s complaint under the law as the court had adopted it, [accordingly Judge Fitzwater adhered to his earlier decision] as the law of the case.¹⁴⁷

Subsequently, a jury acquitted Cuban of all charges after a mere four hours of deliberation.¹⁴⁸

In *SEC v. Lyon*, Judge Sydney Stein of the District Court for the Southern District of New York favored the defendant in another case concerning the existence of a duty of confidentiality to support misappropriation once again concerning a PIPE transaction.¹⁴⁹ After a trial, the court rejected the SEC’s motion for summary judgment on the grounds that, although the SEC had shown that during negotiations the issuer had tried to impose such a duty of confidentiality, a reasonable jury could find that the defendant did not accept such a duty.¹⁵⁰ Following *Chestman*, the court noted “[a]s a matter of law, defendants correctly note that ‘a fiduciary duty cannot be imposed unilaterally by entrusting a person with confidential information.’”¹⁵¹

In *SEC v. Obus*, another judge in the same court, Judge George Daniels, found no breach of duty sufficient to establish insider-trading liability under either the classic or misappropriation theory.¹⁵² Based on the general principles of *Erie Railroad v. Tompkins*, prohibiting the creation of federal common law,¹⁵³ he applied the New York law of duties.¹⁵⁴ This case involved trades by tippees from an employee of GE Capital, which was providing debt financing in connection with a purchase of a publicly traded corporation. The SEC proceeded on two theories: first, that GE Capital, and therefore the tipper, was a temporary insider of the corporation; and second, that the

¹⁴⁶ *SEC v. Cuban*, No. 3:08-CV-2050-D, 2013 U.S. Dist. LEXIS 30324, at *19 (N.D. Tex. Mar. 5, 2013).

¹⁴⁷ *Id.* at *6 n.4.

¹⁴⁸ Ben Protes & Lauren D’Avolio, *Jury Rules for Mark Cuban in Setback for S.E.C.*, N.Y. TIMES (Oct. 16, 2013, 8:42 PM), http://dealbook.nytimes.com/2013/10/16/mark-cuban-cleared-of-insider-trading/?_r=0.

¹⁴⁹ *SEC v. Lyon*, 605 F. Supp. 2d 531, 535 (S.D.N.Y. 2009).

¹⁵⁰ *Id.* at 544.

¹⁵¹ *Id.* at 544 (quoting *United States v. Chestman*, 947 F.2d 551, 567 (2d Cir. 1991)).

¹⁵² *SEC v. Obus*, No. 06 Civ. 3150 (GBD), 2010 U.S. Dist. LEXIS 98895, at *44–45, *50–51 (S.D.N.Y. Sept. 20, 2010).

¹⁵³ *See generally* *Erie R.R. v. Tompkins*, 304 U.S. 64, 78 (1938).

¹⁵⁴ *Obus*, 2010 U.S. Dist. LEXIS 98895, at *34–36.

tipper misappropriated nonpublic information about the corporation from his employer, GE Capital.¹⁵⁵ It is the first theory that concerns us here. In granting the motions for summary judgment for the tippers and tippees, the court stated that liability under both the classic and misappropriation theories required breach of a “fiduciary duty (or [its] functional equivalent).”¹⁵⁶

The court found that it was “undisputed that [the tipper] owed a fiduciary duty to his employer, GE Capital.”¹⁵⁷ With respect to the SEC’s allegation of temporary insider status, the court noted that “[u]nder New York state law, a financial institution typically owes no fiduciary duty to its borrowers.”¹⁵⁸ Indeed, “[t]he arm’s-length relationship of parties in a business transaction is, if anything, antithetical to the notion that either would owe a fiduciary relationship to the other.”¹⁵⁹ The court did note that, although “special circumstances” could result in the creation of a fiduciary duty, they did not exist in this case, and GE Capital did not expressly agree to accept such a duty.¹⁶⁰ The court rejected the SEC’s argument that a duty was created because the corporation marked its communications to GE Capital as confidential:

In the instant case, there is a lack of a specific confidentiality agreement or a retainer payment, and the dearth of facts sufficient to imply communication of an expectation by SunSource or acceptance of a fiduciary duty by GE Capital vis-a-vis the borrower/lender relationship. Additionally, the fact that SunSource was negotiating with other lenders as of the ... date of the alleged tip, establish that no reasonable fact-finder could find the existence of the required *fiduciary* relationship or its functional equivalent. Even if, as alleged, GE Capital received confidential information, and SunSource unilaterally expected it to remain as such, the absence of any ascension on the part of GE Capital to accept such a duty precludes a finding of liability under Section 10b and Rule 10b-5.¹⁶¹

This language suggests that although a duty could be established by contract, it nevertheless must be fiduciary in nature, or its functional equivalent.

The Second Circuit reversed the Southern District’s grant of summary judgment in favor of the defendant on the grounds that the SEC had not established the requisite relationship. Rather, it held that the SEC had presented sufficient evidence to allow the issue of the relationship to go to the jury.¹⁶²

¹⁵⁵ *Id.* at *29–30.

¹⁵⁶ *Id.* at *30.

¹⁵⁷ *Id.* at *48.

¹⁵⁸ *Id.* at *38.

¹⁵⁹ *Id.*

¹⁶⁰ *Id.* at *38–39 (quoting *Scott v. Dime Sav. Bank of N.Y.*, FSB, 886 F. Supp. 1073, 1078 (S.D.N.Y. 1999), *aff’d*, 101 F.3d 107 (2d Cir. 1996)).

¹⁶¹ *Id.* at *43–44 (emphasis added).

¹⁶² *SEC v. Obus*, 693 F.3d 276, 293 (2d Cir. 2012).

Courts have also disagreed as to nature of confidential relationships formed in business clubs. In *United States v. Kim*,¹⁶³ the defendant belonged to a club for young executives in which it was understood that discussions of business matters would be private. Moreover, members were required to sign confidentiality agreements.¹⁶⁴ Nevertheless, the District Court for the Northern District of California held that this did not create the sort of fiduciary-type relationship of trust under the under the misappropriation theory.¹⁶⁵ In contrast, in *SEC v. Kirch*, the District Court for the Northern District of Illinois granted summary judgment against a defendant on the grounds that membership in a business roundtable did establish such a duty.¹⁶⁶ Although one might try to distinguish the two cases on the grounds that the former was a criminal prosecution and the latter an SEC enforcement action, the court did not do so, expressly rejecting the *Kim* analysis.

United States v. Nothorn involved the question as to whether a financial analyst owed the necessary type of duty to the U.S. Treasury with respect to information disclosed in a confidential press conference.¹⁶⁷ The District Court for Massachusetts found that it was not bound by either *Kim* or *Chestman* because these were decided in rival circuits. It was “free to determine that a ‘similar relationship of trust and confidence’ exists even in the absence of a scintilla of superiority or dominance, as other courts (including some federal district courts within the Second Circuit) have done.”¹⁶⁸

At least one court has interpreted *O’Hagan* and its progeny as not requiring a fiduciary or fiduciary-type relationship between a trader and his source under the misappropriation theory. In *SEC v. McGee*, the District Court for the Eastern District of Pennsylvania rejected the defendant’s motion to dismiss on the grounds that the complaint failed to properly allege the requisite duty by holding that the case law only established that a fiduciary-type relationship was sufficient, but not necessary, to establish the requisite duty.¹⁶⁹ An “agreement to maintain business confidences or a history of sharing business confidences [also] suffices.”¹⁷⁰ In this case the defendant, a stockbroker and a classic insider, had

formed a close personal relationship, which engendered mutual trust and confidence arising out of their [Alcoholics Anonymous] membership.

¹⁶³ 184 F. Supp. 2d 1006, 1008 (N.D. Cal. 2002).

¹⁶⁴ *Id.* at 1015.

¹⁶⁵ *Id.*

¹⁶⁶ 263 F. Supp. 2d 1144, 1149–50 (N.D. Ill. 2003).

¹⁶⁷ *See* 598 F. Supp. 2d 167, 170 (D.Mass. 2009).

¹⁶⁸ *Id.* at 176.

¹⁶⁹ 895 F. Supp. 2d 669, 673–74 (E.D. Pa. 2012).

¹⁷⁰ *Id.* at 678.

During a confidential conversation following an AA meeting, the insider told McGee that he had been drinking as a result of pressure from working on the pending sale of [his company] to another company.¹⁷¹

In *SEC v. Conradt*,¹⁷² Judge Jed Rakoff of the Southern District of New York refused the defendants motion to dismiss on the grounds that the SEC had not pled the requisite relationship between an alleged misappropriator and his source.¹⁷³ The source of the information about an upcoming corporate acquisition was an unnamed, young foreign national working as an associate for the law firm representing one of the parties to the transaction.¹⁷⁴ The young man entered into a close friendship with another foreigner, an Australian, who worked as a broker-dealer.¹⁷⁵ During their frequent conversations and hundreds of emails, in which they discussed details of their personal and professional lives, the associate eventually divulged information concerning the deal.¹⁷⁶ After learning that his friend had not only traded on the information, but also tipped a number of friends (who were also charged with insider trading), the distraught Australian broker-dealer abandoned his position in the United States and returned to his native country.¹⁷⁷ Although Judge Rakoff found that the defendants' argument that the SEC did not sufficiently allege that the "bond [between the two men] went beyond mere friendship into an actionable relationship of trust and confidence" was "not without force," he nevertheless allowed the case to proceed by applying the standard that all inferences must be made in favor of the non-moving party.¹⁷⁸ He noted that "the sensitive nature of many of the personal and professional confidences shared between Martin and the Associate bespeak an implicit mutual understanding of confidentiality."¹⁷⁹

In this connection, although Judge Rakoff cited the language of *O'Hagan*, *Chestman*, and *Falcone* requiring that the defendant have a fiduciary or

¹⁷¹ *Id.* at 674 (citations omitted). The same court subsequently rejected the defendant's motion for judgment of acquittal finding that the government had presented sufficient evidence to support the jury's finding beyond a reasonable doubt that the defendant had the requisite duty of "trust and confidence" to his source. *United States v. McGee*, No. 12-236, 2013 U.S. Dist. LEXIS 103895, at *10-11 (E.D. Pa. July 24, 2013).

¹⁷² *SEC v. Conradt*, No. 12 Civ. 8676 (JSR), 2013 U.S. Dist. LEXIS 78381 (S.D.N.Y. June 6, 2013).

¹⁷³ *Id.* at *2-3.

¹⁷⁴ *Id.* at *1-3.

¹⁷⁵ *Id.* at *3-5.

¹⁷⁶ *Id.* at *5-6.

¹⁷⁷ *Id.* at *11.

¹⁷⁸ *Id.* at *15.

¹⁷⁹ *Id.* at *15-16.

equivalent duty to his source, he applied the test of Rule 10b5-2(b) which states that there is an actionable duty

[w]henever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality....¹⁸⁰

Finally, in *SEC v. Yang*,¹⁸¹ Judge Matthew Kennelly, largely ignored the element of duty in dismissing a defendant's motion for summary judgment. The judge correctly ruled that the elements of an insider trading case can be proven by circumstantial evidence,¹⁸² and noted, also correctly in my opinion, that the circumstantial evidence that the defendant had traded securities on the basis of material non-public information and that he acted in a deceptive manner was extremely strong.¹⁸³ However, the judge also found that there was sufficient circumstantial evidence for a jury to find that the defendant "possessed, and knew he possessed, material nonpublic information from persons who owed a fiduciary duty to [the issuer's] shareholders."¹⁸⁴ The court did mention that there was evidence that the defendant had met with directors of the issuer in China the month before the transactions,¹⁸⁵ but did not cite any evidence either that the defendant had a duty of confidentiality to the source of the information or, if the source were these directors, that they had given the information in a manner that met the requirements for "tipping" liability. As we have seen, under the *O'Hagan* rule, the defendant's trading would have been perfectly legal if the source had given him permission to trade.¹⁸⁶

¹⁸⁰ 17 C.F.R. § 240.10b5-2 (2014).

¹⁸¹ *SEC v. Yang*, No. 12 C 2473, 2013 U.S. Dist. LEXIS 162157 (N.D. Ill. Nov. 14, 2013).

¹⁸² *Id.* at *7.

¹⁸³ The defendant invested almost 95 percent of the funds of a fund he managed in out-of-the-money options in a publicly traded Chinese corporation in the two weeks before it announced a going-private transaction at a substantial premium over the market price. *Id.* at *4, *8–9, *11, *13–16, *18–20.

¹⁸⁴ *Id.* at *19. The judge, however, did not offer any theory as to who the source of the information was, and what his duties were.

¹⁸⁵ *Id.* at *11–12.

¹⁸⁶ There was evidence that, while working as a research analyst for one financial firm, he obtained a copy of a proposal labeled "highly restricted" for a management buyout prepared by another investment bank. *Id.* at *13. Despite the fact that the case does not recite any evidence of how the defendant obtained it the court held that a "reasonable jury could find the nature of this proposal and the existence of a fiduciary duty [of the source of the

3. Rules 10b5-1 and 10b5-2

The SEC has reacted to attempts by the Supreme Court and the Second Circuit to cabin insider-trading liability within the confines of the tort of deceit by adopting Rules 10b5-1 and 10b5-2. Rule 10b5-1 provides in relevant part:

[T]he “manipulative and deceptive devices” prohibited by [the antifraud provisions of the Act] include, among other things, the purchase or sale of a security of an issuer, on the basis of material nonpublic information about that security or issuer, in *breach of a duty of trust or confidence* that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.¹⁸⁷

This formulation noticeably does not say that this duty must be fiduciary or its equivalent in nature. Moreover, it makes the relationships of trust and confidence disjunctive, rather than conjunctive.¹⁸⁸

Rule 10b5-2 provides that the purchase and sale of securities on the basis of material, nonpublic information constitutes “misappropriation in breach of a duty of trust or confidence” in certain non-exclusive enumerated circumstances. These include, “whenever a person agrees to maintain information in confidence,” where persons have a “history, pattern or practice of sharing confidences” and “whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling”¹⁸⁹ The Rule limits the scope of when a duty is created in the context of family:

[P]rovided, however, [in the case of duties presumably established by familial relationships] that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep information confidential, because of the parties’ history, pattern, or practice of sharing and

information to the shareholders of the issuer] would have been obvious to” the defendant. *Id.* at * 13. The problems, of course, are that i) the issue in a misappropriation case is not whether or not *someone* had a fiduciary duty to the source of the information, but whether the *defendant* did and, ii) in a tippee case, the issue is whether the tipper received a benefit from tipping the defendant.

¹⁸⁷ 17 C.F.R. § 240.10b5-1 (2014) (emphasis added).

¹⁸⁸ Rule 10b5-1 also provides for affirmative defenses for certain trades and purports to resolve the split among courts as to whether there must be a causal link between a trader’s possession of the information and her trading of securities—subjects beyond the subject of this Article. *Id.* § 240.10b5-1.

¹⁸⁹ 17 C.F.R. § 204.10b5-2.

maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information.¹⁹⁰

In other words, whereas the Second Circuit, concerned with the expansion of the federal criminalization of state-law fiduciary duties, held that *under New York law*, such a duty does not *automatically* exist between spouses because there was no relationship of inequality and dependence (while suggesting that such a duty could be established under certain circumstances), the SEC purports to establish a rebuttable presumption of such a duty! The Second Circuit purported to apply New York law in finding that no duty existed. In contrast, as the SEC would seem to have no authority to make the common law of New York or any other state, it must be attempting to establish a *federal* law of duties for insider trading liability.

Consequently, Bainbridge correctly states: “Whether the SEC has authority to create a rule imposing misappropriation liability on the basis of an arms-length contractual duty of confidentiality—as opposed to a fiduciary duty-based duty of confidentiality—has not been fully tested.”¹⁹¹ Based on the principal that “[l]iability under Rule 10b-5 ... does not extend beyond conduct encompassed by § 10(b)’s prohibition,”¹⁹² there is a question whether the SEC has exceeded its authority in promulgating these rules. Hazen, recognizing that “the trend in recent cases has been to question the validity of the SEC’s view of outsider trading liability,” believes that Rule 10b5-2 gets the policy right.¹⁹³ Nevertheless, he argues that given the differences of opinion on the subject, the inadequacy of the statute, and the confusion of the case law premised on deception, congressional action is called for to clearly redefine unlawful trading based on the “unfair, unequal access” justification rejected in *Chiarella*.¹⁹⁴

Although Nagy does not definitively conclude that Rule 10b5-2 is invalid, she does agree that it is an attempt to jettison the requirement that the trader’s duty be fiduciary or its equivalent.¹⁹⁵ She suggests that:

Rule 10b5-2 affects the legal landscape in even more profound ways. Indeed, both Rule 10b5-2’s caption and its preliminary note rephrase the

¹⁹⁰ *Id.* (emphasis added).

¹⁹¹ Bainbridge, *Inside the Beltway*, *supra* note 25, at 293.

¹⁹² *United States v. O’Hagan*, 521 U.S. 642, 651 (1997).

¹⁹³ Hazen, *supra* note 75, at 887.

¹⁹⁴ *Id.* at 913. “However, as hard as [the courts] may try, the limitations of the current statute do not leave room for a coherent approach to insider and outsider trading.” *Id.* at 913–14.

¹⁹⁵ Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principals*, 94 IOWA L. REV. 1315, 1319–20 (2009) [hereinafter, Nagy, *Demise*]. In a subsequent article, she characterizes her position as “question[ing]” the SEC’s authority to adopt Rule 10b5-2. Nagy, *Entrustment*, *supra* note 2, at 1126 (2011).

Supreme Court's requirement of a fiduciary or similar relationship of "trust and confidence" to one of "trust *or* confidence." This change from the conjunctive to the disjunctive extends the scope of the misappropriation theory considerably.¹⁹⁶

She correctly notes that those cases that eliminate the requirement that the trader's duty be fiduciary in nature also, implicitly, expand unlawful trading beyond the deception paradigm—because silence can only be deceptive if there is a duty to speak—to encompass the "the wrongful use of confidential information."¹⁹⁷ Although she concedes that "a majority of the Supreme Court has yet to endorse a doctrine expansive enough to reflect this view," she seems to welcome this development.¹⁹⁸

I believe, in contrast, that to do so would contradict the language of section 10(b) which the Supreme Court has long interpreted as only encompassing actually deceptive activity.¹⁹⁹ As such, whether it would be good policy to so broaden the scope of insider trading law would seem to be an issue for Congress—not the SEC or the courts.

4. Judicial Reaction

Despite this controversy among academics, so far only one court has *expressly* found Rule 10b5-2 invalid, two have found it valid, one has expressed disapproval in dicta, and a handful have expressed approval in dicta.²⁰⁰

In *Cuban*, Judge Fitzwater of the Northern District of Texas rejected the defendant's arguments that Rule 10b5-2 was invalid on the grounds

¹⁹⁶ Nagy, *Demise*, *supra* note 195, at 1360 (emphasis added) (citations omitted).

¹⁹⁷ *Id.* at 1337, 1337–52.

¹⁹⁸ *Id.* at 1337.

¹⁹⁹ This is the conclusion reached in a recent student note. See Joseph Pahl, Note, *A Heart as Far From Fraud as Heaven From Earth: SEC v. Cuban and Fiduciary Duties Under Rule 10b5-2*, 106 NW. U. L. REV. 1849, 1881 (2012).

²⁰⁰ See *SEC v. Cuban*, 634 F. Supp. 2d 713, 724–25 (N.D. Tex. July 17, 2009) (invalid); *SEC v. Nothern*, 598 F. Supp. 2d 167, 174–75 (D. Mass. 2009) (valid); *United States v. Kim*, 184 F. Supp. 2d 1006, 1014–15 (N.D. Cal. 2002) (valid); *SEC v. McGee*, 895 F. Supp. 2d 669, 677–80 (E.D. Pa. 2012) (disapproval in dicta); *SEC v. Obus*, No. 06 Civ. 3150 (GBD), 2010 U.S. Dist. LEXIS 98895, at *34 (S.D.N.Y. Sept. 20, 2010) (disapproval in dicta), *vacated by* 693 F.3d 276 (2d Cir. 2012); *SEC v. Rocklage*, 470 F.3d 1, 12–14 (1st Cir. 2006) (approval in dicta); *SEC v. Yun*, 327 F.3d 1263, 1273–74 (11th Cir. 2003) (approval in dicta); *United States v. Whitman*, 904 F. Supp. 2d 363, 369–70 (S.D.N.Y. 2012) (approval in dicta); *United States v. Corbin*, 729 F. Supp. 2d 607, 619 (S.D.N.Y. 2010) (approval in dicta); *SEC v. Kornman*, 391 F. Supp. 2d 477, 485–90 (N.D. Tex. 2005) (approval in dicta); *SEC v. Goodson*, No. 1:99-cv-2133-MHS, 2001 U.S. Dist. LEXIS 26493, at *6, *11 (N.D. Ga. Mar. 6, 2001) (approval in dicta).

that the accused trader must have a *pre-existing* fiduciary relationship with the source.²⁰¹ Nevertheless, he dismissed the case on a different theory:

Because Rule 10b5-2(b)(1) attempts to predicate misappropriation theory liability on a mere confidentiality agreement lacking a non-use component, the SEC cannot rely on it to establish Cuban's liability under the misappropriation theory. To permit liability based on Rule 10b5-2(b)(1) would exceed the SEC's § 10(b) authority to proscribe conduct that is deceptive.²⁰²

In *Nothern*, Judge Nathaniel Gorton of the District Court for Massachusetts also found that the defendant's argument that 10b5-2 is invalid because the "SEC lacks the power to promulgate rules inconsistent with the language of § 10(b)" to be "untenable" because the argument "is based entirely upon a law review article and purports to contradict persuasive case law holding that Rule 10b5-2(b) properly defines those circumstances under which misappropriation liability can arise."²⁰³ In any event, this part of the opinion might be dictum because "[r]egardless of SEC Rule 10b5-2(b), the SEC's allegation that [the defendant] expressly agreed to maintain the confidentiality of Treasury information is sufficient to state a claim that he had a 'similar relationship of trust and confidence' upon which Nothern's misappropriation liability may be premised."²⁰⁴

In *Kim*, Judge Charles Breyer of the Northern District of California "questioned the rule's validity,"²⁰⁵ albeit in dictum, because the trades in question occurred before it was in effect.

²⁰¹ See *SEC v. Cuban*, 634 F. Supp. 2d 713, 726–27 (N.D. Tex. July 17, 2009). This argument was supported by an *amicus* brief submitted by Professors Allen Ferrell, Stephen Bainbridge, Alan R. Bromberg, M. Todd Henderson and Jonathan R. Macey. See Amended Brief of Allen Ferrell et al. as Amici Curiae Supporting Defendant's Motion to Dismiss at 1-3, *SEC v. Cuban*, 634 F. Supp. 2d 713 (2009) (No. 3:08-cv-02050). Hazen believes that the court was right to reject this position. See Hazen, *supra* note 75, at 904–05. For a criticism of the court's attempt to distinguish mere non-disclosure agreements from non-use agreements, see Lisa Rachlin, *Recent Developments in the Duty Requirement Under the Misappropriation Theory: A Critique of Cuban's Unintended Consequences*, 11 U.C. DAVIS BUS. L.J. 67, 87–90 (2010).

²⁰² 634 F. Supp. 2d at 730-31. The court's opinion relates only to Rule 10b5-2(b)(1)—applicable confidentiality agreements. It expressly states that its objections do not apply to Rules 10b5-2(b)(2) and (3). *Id.* at 730. As mentioned, this case was reversed and remanded on other grounds. See *supra* note 146 and accompanying text. Upon remand, Judge Fitzwater specifically noted that the requisite duty could be established by contract, express or implied. See *SEC v. Cuban*, No. 3:08-CV-2050-D, 2013 U.S. Dist. LEXIS 30324, at *10–11 (N.D. Tex. Mar. 5, 2013).

²⁰³ 598 F. Supp. 2d at 174.

²⁰⁴ *Id.* at 175.

²⁰⁵ See Hazen, *supra* note 75, at 896 n.78 (citing *United States v. Kim*, 184 F. Supp. 2d 1006, 1014–15 (N.D. Cal. 2002)). Hazen suggests that "if the court was correct that dismissal

In contrast, in *McGee*, Judge Timothy Savage of the District Court for the Eastern District of Pennsylvania found:

In summary, Rule 10b5-2 was promulgated by the SEC in the exercise of the authority granted to it by Congress. Because the Rule was neither arbitrary nor capricious, nor manifestly contrary to the statute, it is entitled to deference.²⁰⁶

Consequently, he found that a close friendship, developed by two alcoholics through their membership in Alcoholics Anonymous, constituted a history, pattern, or practice of sharing confidences within the meaning of the Rule.²⁰⁷

There seems to be an implicit disagreement among judges in the Southern District of New York. Although Judge George Daniels in *Obus* did not consider the issue of the validity of Rule 10b5-2, his opinion rests in part on a principle that is consistent with Judge Fitzwater's analysis in *Cuban*.²⁰⁸ That is, Judge Daniels held that under both the classic and misappropriation theories, the defendant must breach a fiduciary duty or its functional equivalent. Under the rule of *Erie* prohibiting the creation of federal common law, Judge Daniels believed he was required to apply New York's fiduciary duty law. The court held that although Congress could give the SEC statutory "rulemaking powers ... [clarifying] the duty necessary to impose insider trading liability," it had not done so.²⁰⁹ He noted that "[w]hile the SEC may promulgate a rule that imposes such a duty, provided the rule conforms to the rulemaking powers conferred to it by Congress, the SEC, has not requested statutory clarification of the duty necessary to impose insider trading liability."²¹⁰ This suggests that Judge Daniels would likely be inclined to find that Rule 10b5-2 would be invalid to the extent that it is interpreted as purporting to impose liability absent a fiduciary-type duty.²¹¹

In contrast, in *United States v. Corbin*, Judge Victor Marero, also of the District Court for the Southern District of New York, found that an

was mandated by the terms of section 10(b), then Rule 10b5-2(b)(2) is overbroad since the SEC cannot by rule extend the scope of the statute." *Id.*

²⁰⁶ SEC v. McGee, 895 F. Supp. 2d 669, 680 (E.D. Pa. 2012).

²⁰⁷ *Id.* at 677–80.

²⁰⁸ See SEC v. Obus, No. 06 Civ. 3150 (GBD), 2010 U.S. Dist. LEXIS 98895 (S.D.N.Y. Sept. 20, 2010).

²⁰⁹ *Id.* at *36.

²¹⁰ *Id.* at *35–36.

²¹¹ The Second Circuit reversed Judge Daniel's grant of summary judgment in favor of the defendants on the grounds that the SEC had alleged sufficient evidence for the case to proceed. Its opinion repeatedly referred to the necessary duty owed by a misappropriator as being fiduciary in nature. See SEC v. Obus, 693 F.3d 276, 284–85, 287–88 (2d Cir. 2012). In this case, because the misappropriator was an employee of the source, his duty was clearly fiduciary. See *id.* at 290 (citing RESTATEMENT (THIRD) OF AGENCY § 8.05(2) (2006)).

indictment sufficiently alleged that the defendant had the requisite duty to his source under the alternate grounds of an express confidentiality agreement, a history, pattern, or practice of sharing confidences, or the spousal relationship.²¹² In doing so, he characterized Rule 10b5-2 as a “codification” of the case law consistent with the Second Circuit’s *Chestman* rule.²¹³ He expressly concluded “that the SEC’s construction of § 10(b) embodied in Rule 10b5-2” is valid based on a *Chevron* analysis.²¹⁴

In *United States v. Whitman*, Judge Jed Rakoff, a third judge in the Southern District of New York, held, “[t]he scope of an employee’s duty to keep material non-public information confidential is defined by federal common law,” in the context of the liability of tippees of a classic insider.²¹⁵ In doing so, Judge Rakoff noted that in promulgating Rule 10b5-2, the SEC promoted a policy of a uniform standard throughout the country.²¹⁶ Similarly, in *SEC v. Yang*,²¹⁷ Judge Matthew Kennelly of the Northern District of Illinois cited the rule in his finding that a duty of confidence had been created between an unmarried couple.

Other courts have cited the rule with favor, albeit perhaps as dictum. In *SEC v. Goodson*,²¹⁸ Judge Martin Shoob of the Northern District of Georgia noted that although Rule 10b5-2 established a federal law of duty between spouses, it was inapplicable because it was promulgated after the trading occurred.²¹⁹ Similarly, in *SEC v. Kornman*,²²⁰ Judge Sam Lindsay of the Northern District of Texas found that an attorney had the requisite duty of confidentiality to potential clients either because he was a fiduciary under *Chestman*, or because he received nonpublic information in confidence “bolstered” by the SEC’s adoption of Rule 10b5-2 once again subsequent to the trading at issue.²²¹ In *SEC v. Rocklage*,²²² the First Circuit Court of

²¹² *United States v. Corbin*, 729 F. Supp. 2d 607, 615–17 (S.D.N.Y. 2010).

²¹³ *Id.* at 616.

²¹⁴ *Id.* at 619. One commentator similarly argues that the lower court decision in *Cuban* is incorrect on a *Chevron* analysis. See Robert Bailey, Jr., *SEC v. Cuban: The Misappropriation Theory and Its Application to Confidentiality Agreements Under Section 10(b) and Rule 10b5-2 of the Securities Exchange Act of 1934*, 35 DEL. J. CORP. L. 539, 554–57 (2009). Contra Tyler J. Bexley, Note, *Reining in Maverick Traders: Rule 10b5-2 and Confidentiality Agreements*, 88 TEX. L. REV. 195, 196–97, 204–15 (2009); DeSoto, *supra* note 143, at 298–99; and Pahl, *supra* note 199, at 1873–79.

²¹⁵ *United States v. Whitman*, 904 F. Supp. 2d 363, 374 (S.D.N.Y. 2012).

²¹⁶ *Id.* at 369–70.

²¹⁷ *SEC v. Yang*, 2013 U.S. Dist. LEXIS 162157, at *24 (N.D. Ill. Nov. 14, 2013).

²¹⁸ *SEC v. Goodson*, No. 1:99-cv-2133-MHS, 2001 U.S. Dist. LEXIS 26493 (N.D. Ga. Mar. 6, 2001).

²¹⁹ See *id.* at *6–8, *11–12.

²²⁰ *SEC v. Kornman*, 391 F. Supp. 2d 477 (N.D. Tex. 2005).

²²¹ See *id.* at 489–90.

²²² *SEC v. Rocklage*, 470 F.3d 1 (1st Cir. 2006).

Appeals stated that, under the facts of the case, a fiduciary-type relationship of confidentiality had developed between spouses.²²³ The court also states, however, that the defendants “do not seriously challenge the SEC’s allegation that Mrs. Rocklage breached a duty she owed to her spouse under” Rule 10b5-2.²²⁴

Finally, in *SEC v. Yun*,²²⁵ the Eleventh Circuit took two arguably contradictory positions in dictum. On the one hand, it stated that the fact that the SEC promulgated Rule 10b5-2 after the date of the trading at issue “bolstered” its holding that under the facts of that case the spouses bore the requisite duty of “loyalty and confidentiality” to each other.²²⁶ On the other hand, it stated that “the SEC’s new rule goes farther than we do in finding a relationship of trust and confidence.”²²⁷ As Hazen has noted, “[s]ince the SEC cannot by rule extend the scope of the section 10(b) beyond what Congress intended, it would seem to follow that in the court’s view Rule 10b5-2 exceeds the scope of the statute.”²²⁸

What is at stake here, other than the scandal that we countenance, is effectively a federal common law—criminal law regime. As John Coffee warned as early as 1991, *Carpenter* and other cases have literally made a violation of state law fiduciary duties into a federal case—and often a federal *criminal* case at that.²²⁹ As I have emphasized, it is black-letter law

²²³ *Id.* at 3–4, 7. According to the court:

From the time that Mr. Rocklage joined Cubist in 1994, he had routinely communicated material, nonpublic information to his wife, and she had always kept the information confidential. Based on Mrs. Rocklage’s agreement, and based on their prior history of sharing nonpublic information about the company and her keeping that information confidential, Mr. Rocklage had a reasonable expectation that she would not disclose the trial results to anyone. Based on his understanding that she would keep the information confidential, Mr. Rocklage informed his wife that the clinical trial had failed. Before the results were disclosed to her, Mrs. Rocklage understood her husband’s expectation of confidentiality.

Id.

²²⁴ *Id.* at 7.

²²⁵ *SEC v. Yun*, 327 F.3d 1263 (11th Cir. 2003).

²²⁶ *Id.* at 1273.

²²⁷ *Id.* at 1273 n.23.

²²⁸ Hazen, *supra* note 75, at 895 n.75. See also Pahl, *supra* note 199, at 1864.

²²⁹ See John C. Coffee, Jr., *Does Unlawful Mean Criminal: Reflections on the Disappearing Tort/Crime Distinction in American Law*, 71 B.U. L. REV. 193, 205 (1991) [hereinafter Coffee, *Reflections*]; see also John C. Coffee, Jr., *Hush!: The Criminal Status of Confidential Information After McNally and Carpenter and the Enduring Problem of Overcriminalization*, 26 AM. CRIM. L. REV. 121, 122–24, 126–32, 138–42, 147–54 (1988); John C. Coffee, Jr., *From Tort to Crime: Some Reflections on the Criminalization of Fiduciary Duties and The Problematic Line Between Law and Ethics*, 19 AM. CRIM. L. REV. 117, 117–30, 149–59 (1981).

that an employee as agent may not obtain a material benefit from a third party from her position with her employer–principal,²³⁰ and may neither use her principal’s property for her own benefit nor disclose her principal’s confidential information to third parties.²³¹ Traditionally, however, violations of these duties merely gave the principal a cause of action against the disloyal agent. *Carpenter*, in contrast, provides for government intervention into employment disputes.

Rule 10b5-2 and the case law that expands misappropriation liability to contractual relationships further criminalize ordinary contract breaches.²³² Moreover, all contracts contain promises. Does this mean that a contract party always “feigns” honesty? Surely it proves too much to imply from this that breaches of contracts are frauds unless the breaching party discloses her intent to do so. So finding ignores Benjamin Cardozo’s classic distinction between the mere “morals of the marketplace” that govern contracts and the “punctilio of an honor the most sensitive” that characterizes fiduciary duties.²³³ This worry about the over-extension of civil and criminal liability animated the Second Circuit’s refusal to presume the existence of fiduciary duties between family members in *Chestman* and was one of the reasons why the Fourth Circuit Court of Appeals rejected the misappropriation theory in the pre-*O’Hagan* case of *United States v. Bryan*.²³⁴

The Supreme Court has tried to limit the scope of their expansive reading of fraud in two ways. First, as the term “misappropriation” indicates, it has tied securities fraud to the theft of intellectual property. This goal is not merely far afield from that of prohibiting securities fraud; it might be antithetical to it.²³⁵ Second, it has tried to add a more restrictive concept of

²³⁰ See RESTATEMENT (THIRD) OF AGENCY § 8.02 (2006).

²³¹ See RESTATEMENT (THIRD) OF AGENCY § 8.05(1) (2006).

²³² As stated in a recent student note:

it would be unreasonable for the courts to interpret Section 10(b) to punish mere breaches of contract. By premising insider trading liability on a confidentiality agreement, Rule 10b5-2 essentially criminalizes a breach of contract. Contract law, however, makes clear that “[w]hile a contract may indeed have the force of law, breach of a contract is not necessarily an illegal activity. It is a civil breach of an obligation imposed by the contract.”

Bexley, *supra* note 214, at 212–13 (citing *Cram Roofing Co. v. Parker*, 131 S.W.3d 84, 91 (Tex. App. 2003)).

²³³ *Meinhard v. Salman*, 164 N.E. 545, 546 (N.Y. 1928). See also, *Coffee, Reflections*, *supra* note 229, at 207. Of course, some would argue that fiduciary duties are merely default rules that apply in certain relations of dependence and can or should be alterable by contract. The issue of the source of fiduciary duties is beyond the scope of this Article.

²³⁴ See *United States v. Bryan*, 58 F.3d 933, 943 (4th Cir. 1995). I discuss this case *infra* note 367 and accompanying text.

²³⁵ See *supra* note 79 and accompanying text.

when a misappropriation of nonpublic information is “in connection with the purchase and sale of securities.”²³⁶ As I discuss in the next sections, there is so little case law exploring these limitations so it is not clear how much of them continue to exist as a practical matter. Moreover, it is very hard to understand how they can be applied in the congressional context.

C. The “Taking of Property” Element

If the classic theory implicitly holds that certain information belongs to the investing public, the misappropriation theory *expressly* depends on the proposition that some information does not belong to the public, but is the property of the source. That is, as the very term “misappropriation” implies, this fraud requires that the fraudster deprive an owner of its proprietary rights in information conceptualized as intellectual property.

In good Hegelian fashion, the Supreme Court recognizes that possession of intellectual property consists of the right to exclude others.²³⁷ This means that a dishonest confidant misappropriates intellectual property when he deprives the source of its “its exclusive use” by using it for his own purposes. This is fraud because a fiduciary makes an actual or implied representation of honesty on which the source relies. That is, he feigns honesty when he receives a confidence with intent to breach. This, in turn, is “in connection with” when the dishonest confidant “consummates” the fraud by buying or selling securities. In Justice Ginsburg’s words:

A company’s confidential information, we recognized in *Carpenter*, qualifies as property to which the company has a right of exclusive use.... The undisclosed misappropriation of such information, in violation of a fiduciary duty, the Court said in *Carpenter*, constitutes fraud akin to embezzlement—“the fraudulent appropriation to one’s own use of the money or goods entrusted to one’s care by another.”²³⁸

In *Carpenter*—in which the Supreme Court upheld the misappropriation theory in the context of wire fraud, while splitting four–four on its application to securities fraud—Justice White stated that “confidential business information has long been recognized as property.”²³⁹ He explained that the fraudster met the element of obtaining the source’s “property” through deception because the source was “deprived of its right to exclusive use of the

²³⁶ *Bryan*, 58 F.3d at 946.

²³⁷ See *United States v. O’Hagan*, 521 U.S. 642, 652 (1997); Schroeder, *Unnatural Rights*, *supra* note 38, at 475–76.

²³⁸ 521 U.S. at 654 (citations omitted) (quoting *Carpenter v. U.S.*, 484 U.S. 19, 25–27 (1987)).

²³⁹ 484 U.S. at 26.

information, for exclusivity is an important aspect of confidential business information and most private property for that matter.”²⁴⁰ Given this, it is surprising that courts rarely discuss the property element of misappropriation directly. This might be because in many cases, this element seems to obviously have been met. Two cases, however, illustrate problematic aspects of this element.

1. *Talbot*

In *SEC v. Talbot*,²⁴¹ the Ninth Circuit upheld a civil judgment against a trader under the misappropriation theory in a fact pattern in which arguably the source might not have had a proprietary interest in the information. The defendant, Thomas Talbot, was a director of Fidelity National Financing. Fidelity, in turn, was a ten percent shareholder of LendingTree, a public company. LendingTree informed Fidelity that it was in the final stages of negotiating to sell itself to another company. LendingTree disclosed this information to Fidelity because it would need the major shareholder’s approval for the deal.²⁴² This information was, in turn, relayed to Fidelity’s board, including Talbot, at a formal directors’ meeting. Talbot then purchased call options on LendingTree stock. He exercised the calls after LendingTree announced the sale, earning himself a tidy profit.²⁴³ The court easily disposed of the defendant’s specious claims that either he did not receive, or did not know that he received, the information from Fidelity in a relationship of trust and confidentiality.²⁴⁴ Certainly, discussions among directors at a formal board meeting concerning the disposition of a major asset would be confidential under Delaware corporate law.²⁴⁵ There was also evidence that there was some discussion that the board members should not trade on securities based on the information.²⁴⁶

The court of appeals upheld the lower court’s finding that the SEC failed to prove that either Fidelity or the defendant had a duty of confidentiality to LendingTree.²⁴⁷ However, it rejected the lower court’s holding that the misappropriation theory requires that there be an unbroken chain of confidential relationships from the trader back to the *original* source of the information (that is, LendingTree).²⁴⁸

²⁴⁰ *Id.* at 26–27.

²⁴¹ 530 F.3d 1085 (9th Cir. 2007).

²⁴² *See id.* at 1088.

²⁴³ *See id.* at 1087–89.

²⁴⁴ *See id.* at 1094–95.

²⁴⁵ *See id.* at 1095.

²⁴⁶ *See id.* at 1088.

²⁴⁷ *See id.* at 1092.

²⁴⁸ *See id.* at 1092–93.

As so characterized, this would seem to be correct; to do so would reduce the misappropriation theory to the “temporary insider” variation of the classic theory. However, in so holding, the court may have been a little too quick in dismissing a point implicit in the defendant’s argument—namely, that in order for information to be misappropriated, the person who disclosed the information to the disloyal confidant must have a proprietary interest in that information. Information about LendingTree’s nonpublic negotiations to sell itself would seem to be proprietary to *only* LendingTree, but the court thought that neither Fidelity nor Talbot had any duty to LendingTree absent a confidentiality agreement. Consequently, the issue then becomes whether Fidelity had its own proprietary interest in the information that Talbot—Fidelity’s fiduciary—could misappropriate.

The Ninth Circuit did not make a finding of this essential element of a misappropriation case. Perhaps as a practical matter, this lapse is not very significant. *Both* Lending Tree and Fidelity could have their own separate intellectual property interests in aspects of the nonpublic information. With respect to LendingTree, the negotiations to sell the company itself would belong to LendingTree. With respect to Fidelity, knowledge concerning a potential disposition of a significant corporate asset (its LendingTree stock) could be information that belonged to Fidelity.

2. *Rocklage*

SEC v. Rocklage,²⁴⁹ however, arguably provides a more serious problem. In this case, the chairman and CEO of a public bio-chemical company learned the material, nonpublic information that one of the company’s drugs had failed a trial. He disclosed this information to his wife, who tipped off her brother, who in turn tipped off a friend, who traded in the issuer’s stock.²⁵⁰ Upon considering an appeal from a denial of a motion to dismiss, the First Circuit found that the tipper and the tippees could not be tried under the *classic* theory because the wife-tipper was neither a traditional nor temporary insider of the issuer.²⁵¹ However, the court found that the wife-tipper had a fiduciary duty to her husband-source under the facts of this case. Consequently, she committed misappropriation when she communicated material, nonpublic information she obtained from her husband.²⁵²

The unasked question, however, is did the tipper’s source, her husband, have any proprietary interest in the information? The Supreme Court

²⁴⁹ See *SEC v. Rocklage*, 470 F.3d 1 (1st Cir. 2006).

²⁵⁰ See *id.* at 1–4.

²⁵¹ See *id.* at 5.

²⁵² See *id.* at 7.

in *O'Hagan* stated that misappropriation occurs when the source is deprived of its right to exclusive use of the information.²⁵³ The issuer had a right of exclusive use in this information under an *O'Hagan* analysis, but the Court found that the defendant had *no duty to the issuer*. Under the abstain-and-disclose rule of classic insider trading, the husband-source had no right to use the information for his own purposes, exclusive or not. That is, if the husband, rather than the issuer, is considered the source of the information, it is not clear how he could have had a proprietary interest so that it could be misappropriated.

Nevertheless, despite the difficulties with the court's reasoning, the outcome seems intuitively correct within the usual parameters of insider trading case law. It would have been analytically preferable for the court to have applied the *classic* theory and found that the wife-tipper had a derivative duty to the issuer as source because there was an unbroken chain of fiduciary-type relationships (such as, from wife to husband-officer back to issuer-source, and from husband-officer to corporation) so that she would be a "temporary" insider.

D. The "In Connection With" Element

Fraud, or misappropriation of property can only violate § 10(b) if it is "in connection with the purchase and sale of securities." Justice Ginsburg held in *O'Hagan*:

[t]his element 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. The securities transaction and the breach of duty thus coincide.²⁵⁴

Both the majority and the minority agreed that the mere fact of trading standing alone would not satisfy this element.²⁵⁵ Indeed, the government argued for a much *narrower* interpretation of the law than that adopted by the majority!²⁵⁶ What would satisfy the "in connection with" element was the biggest bone of contention between the majority and the minority.²⁵⁷

The reason why *O'Hagan* violated his duty of confidence to his client, Grand Met, and to his firm, was in part because he needed money quickly to pay back funds that he embezzled from another client.²⁵⁸ The government

²⁵³ See *United States v. O'Hagan*, 521 U.S. 642, 654 (1997).

²⁵⁴ *Id.* (emphasis added).

²⁵⁵ See *id.* at 655–59.

²⁵⁶ See *id.* at 684.

²⁵⁷ See *id.* at 655–59.

²⁵⁸ *Id.* at 648.

conceded that if he had used this embezzled *money* to purchase securities, the “in connection with” element would not be met because the relationship between the fraud and the purchase would be too attenuated.²⁵⁹ Justice Thomas recounted that

[i]n such a case, the Government states, “the proceeds would have value to the malefactor apart from their use in a securities transaction, and the fraud would be complete as soon as the money was obtained. In other words, money can buy, if not anything, then at least many things; its misappropriation may thus be viewed as sufficiently detached from a subsequent securities transaction that § 10(b)’s “in connection with” requirement would not be met.... Observing that money can be used for all manner of purposes and purchases, the Government urges that confidential information of the kind at issue derives its value *only* from its utility in securities trading.”²⁶⁰

Justice Ginsburg thought that the government’s argument was unnecessarily narrow and ruled that it was sufficient if the information stolen was “*of a sort* that misappropriators *ordinarily* capitalize upon to gain no-risk profits through the purchase or sale of securities.”²⁶¹ Unfortunately, as Justice Thomas points out, she gives no guidance as to what it means for information to be “of a sort” that is “ordinarily” used for no-risk profits, seemingly thinking that it was self-evident in this case.²⁶²

Perhaps even more unfortunately, Justice Thomas made a weak argument in support of his excellent point that Justice Ginsburg’s distinction is amorphous:

In this case, for example, upon learning of Grand Met’s confidential takeover plans, O’Hagan could have done any number of things with the information: He could have sold it to a newspaper for publication; he could have given or sold the information to Pillsbury itself; or he could even have kept the information and used it solely for his personal amusement, perhaps in a fantasy stock trading game Any of these activities would have deprived Grand Met of its right to “exclusive use” of the information and, if undisclosed, would constitute “embezzlement” of Grand Met’s informational property.²⁶³

The reference to fantasy stock trading verges on silly. Justice Ginsburg was speaking about ordinary *financial* uses of the information—what she

²⁵⁹ *Id.* at 656 (quoting Brief for the United States at 24 n.13, *United States v. O’Hagan*, 521 U.S. 642 (1997) (No. 96-842), 1997 WL 86306, at *24).

²⁶⁰ *Id.* at 656–57 (citations omitted).

²⁶¹ *Id.* at 656 (emphasis added).

²⁶² *See id.* at 681–85.

²⁶³ *Id.* at 685–86 (citations omitted).

called “no risk profits.” Preferably, Justice Thomas might have said something like:

“OK, the tender-offer fact pattern seems easy at first blush—the most obvious way to make money off of the stolen information would be either to short the stock of the bidder or go long on the stock of the target. But it is not really that simple. Perhaps one import of the information is that consumer food companies are now in play. What if O’Hagan started buying stock in RJR Nabisco? Or sold this information to Nabisco’s management?”

Indeed his point is that

the majority’s assertion that the alternative uses of misappropriated information are not as profitable as use in securities trading is speculative at best. We have no idea what is the best or most profitable use of misappropriated information, either in this case or generally. We likewise have no idea what is the best use of other forms of misappropriated property, and it is at least conceivable that the best use of embezzled money, or securities themselves, is for securities trading. If the use of embezzled money to purchase securities is “sufficiently detached” from a securities transaction, then I see no reason why the non-“inherent” use of information for securities trading is not also “sufficiently detached” under the Government’s theory. In any event, I am at a loss to find in the statutory language any hint of a “best-use” requirement for setting the requisite connection between deception and the purchase or sale of securities.²⁶⁴

In other words, Justice Thomas accuses Justice Ginsburg of assuming the very fact—that the information is of a sort ordinarily used to makes risk-free trades—that she claims is an essential element of the cause of action.

E. The “Of a Sort Ordinarily Used” Element

There is virtually no case law that expressly discusses the element of the misappropriation theory that formed the primary basis of the split between Justices Ginsburg and Thomas in *O’Hagan*, namely that the misappropriated information be of a sort *ordinarily* used in the trading of securities. It is not at all clear what Justice Ginsburg meant by the word “ordinarily.” She apparently did not mean “exclusively,” because she rejected the Government’s argument “that confidential information [be] of the kind [that] derives its value *only* from its utility in securities trading.”²⁶⁵ But the word “ordinarily” connotes something more than “possibly.” Does it imply “usually”? What if there are multiple financial uses of the information? Should we ask which use would be more likely? I have no idea.

²⁶⁴ *Id.* at 688 n.4.

²⁶⁵ *Id.* at 657.

The lack of case law might at first blush suggest that this element is no longer a factor. Upon further consideration, it might be merely because the vast majority of SEC actions have been brought in a few general categories of fact patterns that are relatively uncontroversial: (i) the purchase of securities in a target of an unannounced acquisition and (ii) the purchase of securities in a public company immediately prior to the announcement of firm-specific financial information. Indeed, of the fifty-eight insider-trading actions brought by the SEC in 2012 highlighted on its website, twenty involved trading of this sort—as did the high profile prosecutions of Raj Rajaratnam and Rajat Gupta.²⁶⁶

A planned acquisition (in the form of a tender offer) was, of course, found to be “of a sort” in *O’Hagan*. I would also agree that earnings reports and other firm-specific financial information seem intuitively to be “of a sort.” Of course, most SEC actions are settled before they generate any opinions, and the SEC does not even highlight all the cases it commences.²⁶⁷ Consequently, it is difficult to know the entire universe of fact patterns that have generated enforcement actions.

1. PIPE

Two recent cases (discussed above)²⁶⁸ seem relatively unproblematic in that they involved another category of firm-specific information that can be expected to have a predictable effect on the price of that firm when announced. These are “private investment in public equity,” or PIPE transactions. Because they are dilutive of existing share value, they almost always

²⁶⁶ Specifically, thirteen cases involved trading in the target of a merger or other acquisition and six involved trading in the stock of an issuer prior to earnings announcements. Additionally, two involved trading in the stock of pharmaceutical companies prior to announcements concerning drug testing, a fact pattern I discuss immediately below. One case involved all three types of information. See *SEC Enforcement Actions: Insider Trading Cases*, U.S. SEC. AND EXCH. COMM’N, <http://sec.gov/spotlight/insidertrading/cases.shtml> (last visited Jan. 12, 2014).

One of the fact patterns in the Rajaratnam and Gupta cases differed slightly from the classic *O’Hagan* fact pattern, in that it did not involve the attempted acquisition of an entire company, but the purchase of a major investment in Goldman Sachs by Warren Buffett’s Berkshire Hathaway at the height of the financial crisis. See Peter Lattman, *Dealbook; Insider Trading Case Focuses on Defendant’s Character*, N.Y. TIMES (June 12, 2012), <http://query.nytimes.com/gst/fullpage.html?res=9905E0DA1239F931A25755C0A9649D8B63>.

²⁶⁷ For example, the SEC claims that it brought fifty-eight insider-trading enforcement actions in 2012, although it only highlighted twenty-three on its website. See *SEC Enforcement Actions: Insider Trading Cases*, U.S. SEC. AND EXCH. COMM’N, <http://sec.gov/spotlight/insidertrading/cases.shtml> (last visited Jan. 12, 2014).

²⁶⁸ SEC v. Cuban, 620 F.3d 551 (5th Cir. 2010); SEC v. Lyon, 605 F. Supp. 2d 531 (S.D.N.Y. 2009).

decrease the price of a corporation's stock.²⁶⁹ Several other SEC actions concerning trading ahead of PIPE were settled.²⁷⁰

2. Drug Trials

Another set of actions involves trading in the stock of pharmaceutical companies on the nonpublic information concerning clinical trials or government approval of drugs being developed by those companies. In *SEC v. Rocklage*, for example, the First Circuit stated, without discussion, that the fact that one of a corporation's key drugs had failed a clinical trial was "the sort of information 'that misappropriators ordinarily capitalize upon to gain no-risk profits through the purchase or sale of securities.'"²⁷¹

In 2011 the SEC brought a civil action against Sheng Yi Liang, a chemist employed by the Food and Drug Administration, accusing him of insider trading under the misappropriation theory in nineteen different publicly traded companies based on advance knowledge of FDA decisions, both positive and negative, on the companies' drug applications.²⁷² In 2012, the SEC brought civil actions against Matthew Martoma, a portfolio manager, his investor-advisor-employer, and Sidney Gilman, a doctor and medical school professor who oversaw clinical trials of an Alzheimer drug being jointly developed by two publicly-traded pharmaceutical companies. Allegedly, Martoma paid Gilman to disclose non-public information about the progress of the trials, positive and negative, in violation of confidentiality agreements between Gilman and his clients. This permitted Martoma to cause certain

²⁶⁹ In a PIPE transaction an investor buys unregistered stock in a public company in a private transaction with the promise that the company will register the investor's resale of the stock as soon as possible. Because PIPEs are usually last ditch attempts of an issuer to raise capital, shares tend to be sold at a discount from the market price. Consequently, the price of an issuer's shares tends to decrease when such a transaction is announced. See generally Snell & Wilmer LLP, *Raising Capital Through a PIPE Transaction*, THE CORPORATE HANDBOOK SERIES (2006), http://www.swlaw.com/assets/pdf/publications/2007/02/01/PIPE_Feb2007.pdf (discussing PIPE transactions generally). It would seem obvious that there will be conflicting incentives for the issuer and the PIPE investor with respect to disclosure. The issuer would want to keep a pending transaction confidential until it is consummated in order to keep the stock price as high as possible, and the investor would like to disclose the information prior to consummation in order to negotiate a lower price. As a PIPE investor would not ordinarily have any fiduciary duty to the issuer or its shareholders prior to the purchase, the issue of disclosure and non-disclosure is a necessary part of the negotiations of such a deal.

²⁷⁰ See, e.g., Nagy, *Fiduciary Principles*, *supra* note 29, at 1362 n.270.

²⁷¹ 470 F.3d 1, 10 (1st Cir. 2006) (quoting *United States v. O'Hagan*, 521 U.S. 642, 656 (1997)).

²⁷² Amended Complaint ¶¶ 1–2, *SEC v. Liang*, No. 8:11-cv-00819-RWT, 2011 WL 114504 (D. Md. June 2, 2011) [hereinafter, *Liang Complaint*].

portfolios he and another advisor managed to take both long and short positions in the stock of the two companies, allowing them to reap profits or avoid losses aggregating over \$276 million.²⁷³ This case has generated a tremendous amount of information because Martoma was a former employee of the hedge fund SAC Capital Advisors L.P., and therefore threatened to implicate legendary investor Steven A. Cohen.²⁷⁴ In this case, SEC brought an administrative action against Cohen for failure to supervise SAC, and the Justice Department brought a criminal insider trading action against SAC.²⁷⁵ On November 4, 2013, the SAC agreed to plead guilty to all counts of insider trading violations against it and to pay a record fine and forfeitures of \$1.8 billion, “becoming the first large Wall Street firm in a generation to confess to criminal conduct.”²⁷⁶

Interestingly, these cases are similar to a hypothetical posed in a Memorandum by the House Ethics Committee:

For example, a House employee learns in a meeting with Food and Drug Administration (FDA) Staff that a new miracle weight loss drug is going to be approved by the FDA. The staffer is informed at the meeting that the information is confidential. The House employee then buys shares in the company that manufactures the drug. Once the news of the drug approval is made public, the company share price increases and the employee sells at a profit. As the STOCK Act explains, the employee would

²⁷³ Complaint ¶¶ 1, 4, SEC v. CR Intrinsic Investors, LLC, 939 F. Supp. 2d 431 (S.D.N.Y. 2012) (No. 1:12CV08466), 2012 WL 5856296.

²⁷⁴ Peter Lattman & Peter J. Henning, *New Trading Case Casts a Deeper Shadow on a Hedge Fund Mogul*, N.Y. TIMES (Nov. 22, 2012, 8:02 PM), <http://dealbook.nytimes.com/2012/11/22/new-trading-case-casts-a-deeper-shadow-on-a-hedge-fund-mogul/>.

These facts are reminiscent of Sam Waksal’s guilty pleas of criminal insider trading of put options on the stock of ImClone. This case is well known because it is related to the prosecution of Martha Stewart, not for insider trading, but for lying to the government. Schroeder, *Envy*, *supra* note 12, at 2023–25. Waksal, the founder, an officer and director of ImClone, purchased put options on the company’s stock when the FDA informed it that it had decided not to consider its application for approval of its new cancer drug. As such, this was a simple, open-and-shut case of *classic* insider trading.

²⁷⁵ See Steven A. Cohen, Investment Advisers Act Release No. 3634, Admin. Proc. File No. 3-15382 (July 19, 2013), <http://www.sec.gov/litigation/admin/2013/ia-3634.pdf>; see also Indictment, United States v. S.A.C. Capital Advisors, L.P., No. USA-33s-274, 13 Crim 541 (S.D.N.Y. July 25, 2013), [http://www.justice.gov/usao/nys/pressreleases/July13/SACChargingAndSupportingDocuments/SAC%20Indictment%20\(Stamped\).pdf](http://www.justice.gov/usao/nys/pressreleases/July13/SACChargingAndSupportingDocuments/SAC%20Indictment%20(Stamped).pdf). The SEC has also settled a civil action against SAC. See Press Release, Sec. and Exch. Comm’n., CR Intrinsic Agrees to Pay More than \$600 Million in Largest-Ever Settlement for Insider Trading Case (Mar. 15, 2013), available at <http://www.sec.gov/news/press/2013/2013-1.htm>.

²⁷⁶ Ben Protess & Peter Lattman, *After a Decade, SAC Capital Blinks*, N.Y. TIMES, Nov. 5, 2013, at B1. See also Press Release, Manhattan U.S. Attorney Announces Guilty Plea Agreement with SAC Capital Management Companies (Nov. 4, 2013), available at <http://www.justice.gov/usao/nys/pressreleases/November13/SACPleaPR.php>.

be subject to liability for violation of federal civil and criminal insider trading statutes.²⁷⁷

This may or may not be an accurate description of the effect of the statute.

What all these fact patterns have in common is that they only apply to a person who trades securities of the issuer that was developing the drug that was subject to the FDA approval process. The fact that the nonpublic information about the drug was, in fact, used to trade in the stock of the developer is certainly evidence that it is of a sort that *can* be used for this purpose. But does it follow from this that it is of a sort *ordinarily* used for *this* purpose? The SEC does not expressly raise this issue in its complaint against Liang, although it might be setting the background for such an argument when it states:

Liang traded in the securities of developmental drug companies, as opposed to larger drug companies. With respect to developmental drug companies, an FDA decision, positive or negative, would likely have a significant impact on the stock price of the drug company, and therefore generate a greater opportunity to profit.²⁷⁸

It would seem that the information about a drug trial by one company would be both relevant and financially valuable not only to the company developing the drug, but to rival companies working on competing treatments, members of the medical and healthcare professions who treat people with the condition, as well as patients who are considering treatment options.

3. *Pre-publications Articles*

But how would the original misappropriation case of *United States v. Carpenter* be decided under *O'Hagan*? In that case, a *Wall Street Journal* columnist, R. Foster Winans, knowing that the market tended to react to his columns—the popular *Heard on the Street* series—“stole” the *WSJ*'s secret production schedule, which he received as an employee on a confidential basis. That is, knowing what day of the week a specific column would run, he and his co-conspirators would buy or sell securities of issuers to be mentioned in the column the next day. Is this the sort of information that was “ordinarily” used to obtain risk-free profits? Or would it be “ordinarily”

²⁷⁷ Memorandum from United States H.R. Comm. on Ethics to All House Members, Officers, and Employees: New Ethics Requirements Resulting from the STOCK Act (Apr. 4, 2012), <https://ethics.house.gov/sites/ethics.house.gov/files/Stock%20Act%20Pink%20Sheet.pdf>.

²⁷⁸ *Liang Complaint*, *supra* note 272, at ¶ 61.

more valuable to sell to the *New York Times* or the *Financial Times* who would want to scoop their rival publication?²⁷⁹

In perhaps the most closely analogous case, *United States v. Falcone*, then Circuit Judge Sonya Sotomayor, writing for the Second Circuit Court of Appeals, stated that *O'Hagan's* “ordinarily” element was “met in a case where, as here, the misappropriated information is a magazine column that has a known effect on the prices of the securities of the companies it discusses.”²⁸⁰ In the Court’s infelicitous formulation, the “charges arose from a scheme involving the misappropriation of pre-release confidential copies of a magazine column that discussed securities for the purpose of trading in the securities of the featured companies.”²⁸¹

Judge Sotomayor relied on the Second Circuit’s earlier opinion in *Carpenter*,²⁸² which was sustained when the Supreme Court split 4–4 on

²⁷⁹ When *The Wall Street Journal* discovered the scheme, it advised the government and ran a front-page article on the story. I remember poring over the story with fascination as a young associate, for no other reason than the *Journal* made sure to out Winans as the gay lover of the named defendant, Carpenter—a fact that would be unremarkable today, but was extremely scandalous in the early 1980’s, during the height of the AIDS panic.

I would wager the *Journal* was probably not primarily concerned with market integrity, efficiency, preventing securities fraud, or protecting the confidentiality of its production schedule (although these may have been secondary concerns). Rather, as the foremost financial publication in the United States, it was more likely worried about its reputation for journalistic integrity. *The Wall Street Journal*, like most reputable newspapers, has a strict code of journalistic ethics that requires their reporters to avoid any behavior that might raise even a suspicion of a conflict of interest. Indeed, the only reason why Winans’ actions could be deemed misappropriation is because the *Journal's* code imposed such high standards of confidentiality.

Similarly, I would also wager that when the DOJ prosecuted Winans and his friends, it is likely that the Department was not so much concerned with traditional insider trading, but with the prevention of another harm—namely manipulation. Although in this case, Winans apparently did retain some journalistic ethics and did not manufacture false stories purely for the sake of affecting prices, nor did he manipulate the timing of his stories. However, a reporter, who was permitted to trade, would obviously be tempted to do so—which is why the *Journal* and many reputable news sources prohibits such trading. Although manipulation itself can be a crime, it is a notoriously difficult one to prosecute because of the strict requirements of section 9(a), including its “double scienter” element. Consequently, the DOJ tends to bring manipulation cases under section 10(b) as well as 9(a).

²⁸⁰ *United States v. Falcone*, 257 F.3d 226, 233–34 (2d Cir. 2001). This case is probably most well-known for the holding that elements of a tipping allegation under the misappropriation theory differed from those of *Dirks v. SEC*, 463 U.S. 646 (1983), under the classic theory—a topic beyond the scope of this Article.

²⁸¹ 257 F.3d at 227. The Second Circuit had upheld a conviction on almost identical facts under the misappropriation theory in the pre-*O'Hagan* case of *United States v. Libera*, 989 F.2d 596 (2d Cir. 1993). Consequently, an issue was whether the Second Circuit’s interpretation of the theory survived *O'Hagan*.

²⁸² *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986).

appeal. It is not clear, however, whether the Second Circuit's interpretation of this theory in *Carpenter* meets the standard of *O'Hagan*.

Judge Pierce, in *Carpenter*, stated that “the misappropriated information regarding the timing and content of certain [newspaper] columns *had no value whatsoever* to appellants except in connection with their subsequent purchases and sales of securities.”²⁸³ Oddly, in supporting her holding in *Falcone*, Judge Sotomayor observed:

[W]hile the *O'Hagan* majority's response to Justice Thomas's criticism of the “ordinarily” standard was to note his “evident struggle to invent other uses to which O'Hagan plausibly might have put the nonpublic information,” *O'Hagan*, 521 U.S. at 657 n.8, the struggle is not necessarily as difficult in a case in which the information is misappropriated from a publication. In this case, for example, Hudson News employee Salvage began violating company policy in late 1994 by taking copies of golf magazines and *Playboy* magazines and giving them to his neighbor Smath, and Smath appears to have initially added a request for financial magazines simply because he was in the process of learning to be a stockbroker.²⁸⁴

In other words, in support of her conclusions that this information had no other value to the defendant and was of a sort *ordinarily* traded on, she volunteers alternative uses the information could be—and *actually* was—used for!

One might raise my objection to Justice Thomas's unconvincing example of an alternate use of information concerning a planned tender offer—namely that Justice Ginsburg and Judge Sotomayor were speaking about *financial* uses for the information (i.e., “no-risk profits”). But one can fairly readily think of valuable uses of pre-publication information. The defendant might have been able to tip off rival publications or other media outlets to the information in exchange for a kickback.

Moreover, Judge Sotomayor adds this odd footnote:

While the Supreme Court in *O'Hagan*, in the course of reviewing prior decisions in which it had not reached the misappropriation theory question, cited approvingly to a law review article which referred to the misappropriation from a publication in *Carpenter* as constituting an “unusual case” because “the information there misappropriated belonged not to a company preparing to engage in securities transactions, *e.g.*, a bidder in a corporate acquisition, but to the *Wall Street Journal*,” *O'Hagan*, 521 U.S. at 650 n.4, it made no comment regarding the extent, if any, that that unusual element affected whether the misappropriation was “in connection with” a purchase or sale of a security.²⁸⁵

²⁸³ *Id.* at 1033 (emphasis added) (quoting SEC v. Materia, 745 F.2d 197, 203 (2d Cir. 1984)) (internal quotation marks and brackets omitted).

²⁸⁴ 257 F.3d at 234 n.5.

²⁸⁵ *Id.* at 234 n.5 (quoting Barbara Bader Aldave, *The Misappropriation Theory: Carpenter and its Aftermath*, 49 OHIO ST. L.J. 373, 375 (1988)).

In other words, she seems to argue that although the *O'Hagan* majority did note that the journalism facts were “unusual,” the fact that they did not specify whether this difference is meaningful is a reason to conclude that it is not. An alternate implication would be that the majority’s highlighting of the difference meant that it intended that future courts consider that issue.

Another post *O'Hagan* case in the Southern District of New York, *SEC v. Seibald*, also involved a pre-publication tip of information contained in an article.²⁸⁶ Unfortunately, the court did not even mention the “of a sort” element of a misappropriation case. It may have thought it was bound by the earlier Second Circuit opinions in *Carpenter* and the pre-*O'Hagan* case of *United States v. Libera*,²⁸⁷ although it failed to cite either case.

Arguably, however, the fact pattern more easily meets the “in connection” element than do *Carpenter*, *Libera*, and *Falcone*, all of which involve pre-publication information in publications directed to the general public, namely *The Wall Street Journal* and *Business Week*. In *Seibald*, the publications in question were impending research reports by Salomon Brothers, a major investment bank.²⁸⁸ The SEC noted that “as is the case with many reports of this nature, [the defendant’s] reports had the ability to move the market. Investors would read the report and then buy and sell accordingly which would increase or decrease the price of the stock.”²⁸⁹ I would go further. Unlike the articles in the other cases which might be expected to influence trading as a matter of fact, the research reports were distributed to the firm’s clients and salesmen with the express purpose to influence stock trading.²⁹⁰ That is, the reason why a client reads a research report is to help her decide whether to buy, sell, or hold securities; and the reason a salesperson reads them is to help her to persuade clients to trade securities in order to generate commissions.

4. *The Apparent Outlier That Was Not?*

One recent case that does not even mention the “of a sort” requirement might at first blush seem to illustrate how tenuous this element has become.

²⁸⁶ *SEC v. Seibald*, No. 95 Civ. 2081 (LLS), 1997 U.S. Dist. LEXIS 14940 (S.D.N.Y. Sept. 30, 1997) (granting the defendant’s summary judgment motion on one account, but denying it on all other counts).

²⁸⁷ *United States v. Libera*, 989 F.2d 596 (2d Cir. 1993). *Libera* also involved trading based on articles contained in pre-release issues of *Business Week* which were distributed by an employee to his conspirators in violation of his employer’s confidentiality policy. *Id.* at 599. As *O'Hagan* had not yet established the “of a sort” element, it was not discussed.

²⁸⁸ *Seibald*, 1997 U.S. Dist. LEXIS 14940, at *2–3.

²⁸⁹ *Id.* at *4. In *Seibald* the SEC also alleged that the defendant had tipped others off on a merger that Salomon was advising on. *Id.*

²⁹⁰ *Id.* at *3 n.1, *3–4.

It ostensibly involved disclosures about a source's interest in real estate. Upon further consideration, however, this is true only if one reads the facts overly literally and does not read between the lines.

In *SEC v. Berrettini*,²⁹¹ an employee of an acquisition-minded public corporation in the medical services industry would ask a friend—a real estate broker—about properties that happened to be in the cities in which acquisition targets were located. He claimed that this was a part of his employer's due diligence. The employee would not tell the broker that the employer was contemplating a corporate acquisition. Based on this information, the broker would deduce what medical services companies were located in the vicinity, conclude that they were acquisition targets and purchase their securities. In exchange, the broker-tipper would allegedly make kickbacks disguised as loans to the employee-tipper.²⁹² The District Court for the Northern District of Illinois denied the defendant's motion for summary judgment and found that the SEC had presented a sufficient case of insider trading under the tipper–tippee misappropriation theory for the case to proceed.²⁹³

This seems to be a classic case of a disloyal agent profiting from his position that would give the employer–principal a right to recover his ill-gotten gains under the common law of agency. At first blush, the information tipped to the broker–tippee—the employer's interest in real estate—would hardly seem to be of a sort ordinarily used in securities trading. Indeed, this information seems most directly related to the purchase and sale of real estate. This invokes the facts of *Texas Gulf Sulphur*,²⁹⁴ in which the Second Circuit contrasted securities law, which is based on disclosure, and other real property law, which protects secrecy.

However, the court implicitly assumed that the tip of the source's interest in real estate was, in fact, intended as a not-so-subtly disguised tip of the source's true interest in the *owners* of the real estate. That is, the SEC and the defendants disagreed as to

whether Pirtle shared information about the target companies with Berrettini because he was (legitimately) being used as an outside contractor to help Pirtle with his substantial workload, or if the “research projects” that Pirtle claims to have given Berrettini were simply a cover for Pirtle's tips about Philips' business plans.²⁹⁵

²⁹¹ *SEC v. Berrettini*, No. 10-cv-01614, 2012 U.S. Dist. LEXIS 163476 (N.D. Ill. Nov. 15, 2012).

²⁹² *Id.* at *4–12.

²⁹³ *Id.* at *40.

²⁹⁴ *See SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 843–47 (2d Cir. 1968).

²⁹⁵ *Berrettini*, 2012 U.S. Dist. LEXIS 163476, at *4.

In other words, the facts show that the tipper–employee was expressly told that he was subjected to a duty of confidentiality with respect to negotiations concerning the acquisition of businesses, so he tried to get around this by never expressly referring to the targets—but nonetheless strongly hinting at their identity. The court saw through what seems like a crude attempt to comply with the confidentiality agreement in word but not in spirit.²⁹⁶ Interpreted this way, this seems to be yet another in the long line of misappropriation cases involving tips of information from acquirers that led to trading in targets similar to the original *O’Hagan* template.²⁹⁷

5. Common Elements

What these seemingly divergent categories have in common is that they all involve firm-specific information of a type that can reasonably be expected to affect the price of the equity securities of that firm, and the defendants, in fact, traded in equity securities (or options) in that firm. Whether this means the information in these cases was “*of a sort* that misappropriators *ordinarily* capitalize upon to gain no-risk profits through the purchase or sale of securities,” it was a sort that *could* and *was* used for this purpose. This suggests that the SEC and the DOJ have chosen not to push the envelope as to what this element might mean. However, as I already mentioned, in many of these cases, the information could be used for other purposes.

Most obviously, what if someone used such firm-specific information to purchase or sell securities of similarly situated or rival firms? For example, on January 14, 2013, Facebook announced that it would be making an important announcement the following day. It is clear that if Mark Zuckerberg, Facebook’s founder, CEO, and controlling shareholder, purchased shares of Facebook on January 13th, he would be engaging in *classic* insider trading. What if he both understood that such trading would violate the law yet wanted to capitalize on this information? It turned out that the announcement concerned a new search capability. Would he be liable for misappropriation if he purchased put options on search-giant Google’s stock, on the assumption that the announcement of new competition would negatively impact its stock price?

One might argue that, although the nonpublic information was not firm-specific with respect to Google, it nevertheless was relevant to the price of

²⁹⁶ *Id.* at *38–39.

²⁹⁷ The court noted that “[a]ccording to his own testimony, Pirtle understood that the geographic location of the target company was confidential information. He understood that ‘[i]f you disclose the real estate location, then you could easily determine the occupant of the location and the company’s name.’” *Id.* at *8.

Google stock. Indeed, some financial journalists predicted that Google's stock would drop. In fact, the price of Google stock did not change significantly in the next two days, so a short play would have resulted in a loss. This suggests that the information would not have led to risk-free profits in this case. This does not tell us, however, whether it was "of a sort" that could "ordinarily" be capitalized upon to make "risk-free profits in the securities" within Justice Ginsburg's formulation.²⁹⁸

It turns out that the stock that was most affected by the Facebook announcement was neither Facebook's nor Google's, but Yelp's, which describes itself as "an online urban city guide that helps people find cool places to eat, shop, drink, relax and play, based on the informed opinions of a vibrant and active community."²⁹⁹ Presumably, some segment of the market believed that Facebook's new search capacity was likely to impact smaller, specialized social networking firms, not rival search firms.³⁰⁰

The problem becomes even more difficult when we turn to information that is not firm-specific, but which may be expected to positively or negatively affect certain industries. I will turn to this when I discuss the application of the STOCK Act.³⁰¹

F. The "Non-Disclosure" Element

Outsider trading can be securities fraud only if the trader violates a duty of disclosure *to the source* of the information. The corollaries to this are that (i) "if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation—although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty"³⁰² and (ii) there would be no breach if the source gives the fiduciary permission to trade on the information³⁰³ (although, in both of these cases, in the context of a tender offer, the trade might violate Rule 14e-3). As Justice Thomas correctly notes, this seems anomalous because "in either case—disclosed misuse or authorized use—the hypothesized 'inhibiting impact on market participation,' ... would be identical to that from behavior violating the misappropriation theory...."³⁰⁴

²⁹⁸ *United States v. O'Hagan*, 521 U.S. 642, 688 n.4 (1997).

²⁹⁹ *Frequently Asked Questions: What is Yelp?*, YELP, http://www.yelp.com/faq#what_is_yelp (last visited Jan. 12, 2014).

³⁰⁰ Peter Kafta, *Wall Street to Yelp: Facebook Search Should Scare You*, ALLTHINGS.COM (Jan. 16, 2013, 6:15 AM), <http://allthingsd.com/20130116/wall-street-to-yelp-facebook-search-should-scare-you/>.

³⁰¹ See *infra* Part III.

³⁰² 521 U.S. at 655.

³⁰³ This is one of the arguments against the misappropriation theory made by Justice Thomas in his dissent. *Id.* at 689.

³⁰⁴ *Id.* at 689–90 (citations omitted).

Justice Ginsburg refers to this anomaly as an unfortunate example of a statute being under-inclusive.³⁰⁵ This is incorrect. It is mandated by the very logic of her reading of the misappropriation theory, which is premised on the proposition that the source owns the nonpublic information. That is, by definition under trade-secret law, the owner of nonpublic information has the right to exploit it and has no duty to disclose it to the investment public. It follows from this that it also has the right to grant others the right to exploit it.³⁰⁶ I will not explore the notorious implications of this anomaly in detail because I doubt that they are relevant to the problems with congressional trading.

In *O'Hagan*, the language of Justice Ginsburg's opinion can be read literally to say that there is no insider-trading liability so long as the confidant discloses his intent to the source before he trades.³⁰⁷ This is known as the brazen-misappropriator problem.³⁰⁸ In the one case to consider the timing issue, *SEC v. Rocklage*, the First Circuit interpreted *O'Hagan* as providing that disclosure is a "safe harbor" only available if the information was originally obtained without deception.³⁰⁹ That is, the court assumes, despite any express supporting language in the case, that *O'Hagan* only decided to use the information about the impending Pillsbury tender offer for his own nefarious purposes *after* he legitimately received this information.³¹⁰ In contrast, in *Rocklage*, a wife "tricked her husband into revealing confidential information" when she had a pre-existing intent to tip her brother.³¹¹ Consequently, the court was "unwilling to say that *O'Hagan* requires us to conclude that [the defendant's] post-acquisition disclosure of her intention to tip somehow rendered her acquisition of information non-deceptive" and denied the defendants' motion to dismiss.³¹²

Although the First Circuit's analysis seems eminently reasonable within the policy of *O'Hagan*, I am not sure that it can be reconciled with its

³⁰⁵ "[T]he fact that § 10(b) is only a partial antidote to the problems it was designed to alleviate does not call into question its prohibition of conduct that falls within its textual proscription." *Id.* at 659 n.9.

³⁰⁶ See Schroeder, *Envy*, *supra* note 12.

³⁰⁷ See *United States v. Falcone*, 257 F.3d 226, 232 n.3 (2d Cir. 2001) (citing *United States v. O'Hagan*, 521 U.S. 642, 655 (1997)).

³⁰⁸ Nagy, *Fiduciary Principles*, *supra* note 29, at 1344; BAINBRIDGE, *INSIDER TRADING*, *supra* note 31, at 116.

³⁰⁹ *SEC v. Rocklage*, 470 F.3d 1, 12 (1st Cir. 2006).

³¹⁰ Although the Supreme Court did not mention this fact, it strikes me as a not unreasonable assumption. That is, *O'Hagan*, who was not an attorney on this deal, presumably did not inveigle the information from either Grand Met or his partners. Rather, he likely would have learned it in the ordinary course of partnership business and subsequently succumbed to the temptation to use it for his own purposes.

³¹¹ 470 F.3d at 8.

³¹² *Id.* at 12–13.

language. Indeed, in dictum, Judge Fitzwater in *Cuban* rejected this interpretation of *O'Hagan*, noting “it did not hold that the recipient must give the source sufficient notice to enable the source to prevent the recipient’s use of the information.”³¹³

I will not discuss this issue further here. I believe that the likelihood of encountering such a brazen congressional misappropriator is low.³¹⁴

III. APPLICATION OF THE STOCK ACT

In adopting the STOCK Act, Congress did not take up the hard task of defining when securities trading by governmental personnel is unlawful or even inappropriate. Although various earlier versions of the bill had more specific language, they languished in Congress for years until press reports and President Obama’s State of the Union speech made congressional trading a matter of embarrassment.³¹⁵ It is not, perhaps, surprising that this resulted in the quick adoption of a toothless statute. As Jack Maskell, Legislative Attorney with the Congressional Research Service, states in a report to Congress, the STOCK Act was intended to correct the *public misperception* that Congress had exempted itself from the securities laws.³¹⁶ Consequently, the

³¹³ SEC v. Cuban, No. 3:08-CV-2050-D, 2013 U.S. Dist. LEXIS 30324, at *20 n.9 (N.D. Tex. Mar. 5, 2013). Nevertheless, the judge rejected Cuban’s motion for summary judgment on this issue on the grounds “that a reasonable jury could find from the evidence in the summary judgment record that Cuban merely disclosed that he ‘was going to sell,’ not that he specified that he would sell *before* [the source] announced the [nonpublic information.]” *Id.* at *21.

³¹⁴ See SEC v. Obus, No. 06 Civ. 3150 (GBD), 2010 U.S. Dist. LEXIS 98895, at *30 (S.D.N.Y. Sept. 20, 2010). A recent case may present an opportunity to consider the issue of disclosure prior to trading. In *SEC v. Bauer*, 723 F.3d 758 (7th Cir. 2013) the Court of Appeals for the Seventh Circuit reversed and remanded a summary judgment in favor of the SEC in the novel case concerning if, and in what circumstances a mutual fund redemption could constitute unlawful insider trading under the misappropriation theory. The defendant was an officer of the investment advisor that managed the fund whose shares she redeemed. One of the many issues that the lower court was ordered to consider was the defendant’s

two arguments ... as to why her ... redemption cannot be fairly viewed as a deceptive breach of her duty of loyalty to [the investment advisor/ source] and confidentiality ... (1) the [mutual fund/issuer’s] board approved the ... opening of the trade window for [the investment advisor/source’s] employees, which constituted authorization to trade; and (2) [the defendant] identified herself as an ... employee [of the source] when placing the call to redeem her shares, which constituted disclosure to the principal.

723 F.3d at 771 (citing *United States v. O’Hagan*, 521 U.S. 642, 659 n.9 (1997)).

³¹⁵ See Stop Trading on Congressional Knowledge Act of 2012 (STOCK Act), Pub. L. No. 112-105, 126 Stat. 291 (2012).

³¹⁶ JACK MASKELL, CONG. RESEARCH SERV., R42495, THE STOCK ACT, INSIDER TRADING, AND PUBLIC FINANCIAL REPORTING BY FEDERAL OFFICIALS 1–2 (2012), <https://www.fas.org/sgp/crs/misc/R42495.pdf>.

provisions of the act relating to insider trading merely affirm that congressional members are not exempt, “makes explicit the duty of confidentiality and trust that all public employees have concerning material, nonpublic information that comes to them by virtue of their federal employment,” and direct the Ethics Committees of the two houses to adopt rules “‘clarifying’ that Members and staff are prohibited from using nonpublic information derived from their positions ‘as a means for making a private profit.’”³¹⁷ That is, the STOCK Act does not change the law at all. At most it casts a dim light on congressional duties, but leaves the other elements of this notoriously fuzzy cause of action in the dark. In other words, if the SEC and the DOJ felt uncertain in their ability to bring actions against members of Congress and their staffers in the past, they will probably continue to feel this way.

In this section, I discuss the problems of application of the STOCK Act. I will only mention in passing the reporting requirements of the Act, even though their potential shaming effect might do the most for discouraging trading that has the appearance of impropriety. I start, instead, with the least inadequate aspect of the Act’s attempt to make certain trading unlawful: the provision relating to duties. I then dispose quickly with two “loopholes” in the Act, which I believe are likely to be nonissues as a practical matter. I then turn to the remaining elements of the misappropriation theory that the Act does not address.

A. Fiduciary Duties or Their Equivalent

Apparently, Representative Louise Slaughter, co-sponsor of the STOCK Act, believed that the insider-trading prohibitions did not apply to members of Congress and their staffers.³¹⁸ As discussed,³¹⁹ although there was no

³¹⁷ *Id.*

³¹⁸ According to Barbabella et al., “[b]oth Slaughter and the *Wall Street Journal* have quoted Thomas Newkirk, a former SEC official and current partner at Jenner and Block”:

If a congressman learns that his committee is about to do something that would affect a company, he can go trade on that because he is not obligated to keep that information confidential. He is not breaching a duty of confidentiality to anybody and therefore he would not be liable for insider trading.

Barbabella et al., *supra* note 4, at 219 (citing Brody Mullins, *Bill Seeks to Ban Insider Trading By Lawmakers and Their Aides*, WALL ST. J., Mar. 28, 2006, at A1). Andrew George asserts that the legality of congressional trading prior to the STOCK Act was “conventional wisdom,” although he argues that it in fact is unlawful misappropriation. Andrew George, *Public (Self)-Service: Illegal Trading on Confidential Congressional Information*, 2 HARV. L. & POL’Y REV. 161, 162–63 (2008).

³¹⁹ See *infra* notes 328, 331.

express congressional exemption, legal scholars disagreed as to whether members of Congress and their staffers had the type of duties to a source sufficient for a misappropriation case with respect to information obtained from their positions.³²⁰ Bainbridge forcefully argues that staff, who are mere employees of the United States government, might have such a fiduciary or similar duty of confidence to the government. He thinks that it is a stretch, however, to analyze senators and representatives as mere employees.³²¹ Donna Nagy just as forcefully argues that, of course, members of Congress and their staffers “owe fiduciary-like duties of trust and confidence to a host of persons including the citizen-investor whom they serve, as well as the federal government, other members of Congress, and government officials outside of Congress ... who rely on their loyalty and integrity.”³²² Consequently, she believes their trading in securities on the “basis of material nonpublic information obtained through congressional service” would constitute insider-outsider trading if the other elements of the cause of action exist.³²³

There is limited case law in other contexts suggesting government officials have fiduciary duties.³²⁴ For example, in 1988—nine years before *O’Hagan*—the government indicted Robert A. Rough, a former member of the New York Federal Reserve Bank, for insider trading in connection with the leaking of interest rate information to a brokerage firm.³²⁵ The charges were dropped after he pled guilty to one charge of bank fraud.³²⁶

Nagy notes that although members of Congress “have been indicted for defrauding the federal government and its citizen[s] through the misappropriation of funds and other tangible property,” to date there has been no

³²⁰ For a survey of opinions on this issue, see Matthew Barbabella et al., *supra* note 4.

³²¹ Stephen M. Bainbridge, *Insider Trading Inside the Beltway*, 36 J. CORP. L. 281 (2011); see also Barbabella et al., *supra* note 4, at 237.

³²² Nagy, *Entrustment*, *supra* note 2, at 1111.

³²³ *Id.* Nevertheless, she, like me, decries the state of the current law and believes that a “new statute explicitly prohibiting the offense of insider trading would be a very welcome development under the federal securities laws.” *Id.*

³²⁴ Bud W. Jerke, *Cashing in on Capitol Hill: Insider Trading and the Use of Political Intelligence for Profit*, 158 U. PA. L. REV. 1451, 1484 n.166 (2010) (citing *United States v. Woodard*, 459 F.3d 1078, 1086 (11th Cir. 2006); *United States v. Keane*, 522 F.2d 534, 545 (7th Cir. 1975); *United States v. Peltz* 433 F.2d 48, 52 (2d Cir. 1970)). See also *id.* 1484–85. Barbabella and his co-authors note that, although there have been scholarly assertions of fiduciary duties of governmental officials and employees for decades, this “hardly offers a solid legal basis for liability based on the disclose or abstain rule or the misappropriation theory.” Barbabella et al., *supra* note 4, at 216.

³²⁵ Joseph F. Sullivan, *A Former Official of Federal Bank Indicted as Insider*, N.Y. TIMES (Dec. 9, 1988), <http://www.nytimes.com/1988/12/09/business/a-former-official-of-federal-bank-indicted-as-insider.html>.

³²⁶ *Shift by U.S. in Insider Case*, N.Y. TIMES (Aug. 30, 1989), <http://www.nytimes.com/1989/08/30/business/shift-by-us-in-insider-case.html>.

reported case finding liability of an official under the misappropriation theory.³²⁷ In 2011, however, the SEC brought a cause of action against Cheng Yi Liang, a chemist with the FDA, for trading in the stock of pharmaceutical firms based on nonpublic information about FDA decisions concerning their drug applications. In doing so, the SEC relied on the Department of Health and Human Services rules that state:

Government employees are sometimes able to obtain information about some action that the Government is about to take or some other matter which is not generally known. Information of this kind shall not be used by the employee to further his/her or someone else's private financial or other interests. Such a use of official information is clearly a violation of a public trust. Employees shall not, directly or indirectly, make use of, or permit others to make use of information not made available to the general public.³²⁸

The SEC also noted that the

Standards of Ethical Conduct for Employees of the Executive Branch provides that “[a]n employee shall not engage in a financial transaction using nonpublic information, nor allow the improper use of nonpublic information to further his own private interest or that of another, whether through advice or recommendation, or by knowing unauthorized disclosure.”³²⁹

Furthermore, the general principle is that “[p]ublic service is a public trust. Each employee has a responsibility to the United States Government and its citizens to place loyalty to the Constitution, laws and ethical principles above private gain.”³³⁰

Although these formulations do not use the specific language “fiduciary duty,” the standards imposed by these policies are so high that it might satisfy even those required by the Second Circuit, and would support an insider trading action *if* the other elements of misappropriation were met.³³¹ In contrast, the STOCK Act neither adopts the high standards of the HHS regulation nor refers to fiduciary duties. Rather, the STOCK Act references the controversial language of Rules 10b5-1 and 10b5-2 by stating that covered

³²⁷ Nagy, *Entrustment*, *supra* note 2, at 1149. She refers specifically to former Representatives Charles Diggs and Daniel Rostenkowski and former Senator David Durenberger.

³²⁸ *Liang Complaint*, *supra* note 272, at ¶ 46 (citing 45 C.F.R. § 73.735-307(a)(4) (2014) (setting forth the ethics rules for the use of official information by employees of the Department of Health and Human Services)).

³²⁹ *Id.* ¶ 47 (citing 5 C.F.R. § 2635.703(a) (2014)).

³³⁰ *Id.* ¶ 50 (citing 5 C.F.R. § 2635.101(a) (2014)).

³³¹ The case is, in fact, being brought in the Maryland District Court, which is in the Fourth Circuit.

persons have a “duty arising from a relationship of trust and confidentiality with respect to certain information,” but only for the purposes of the insider trading prohibitions of the ’34 Act.³³²

Interestingly, the Senate Committee of Ethics’s December 4, 2012 Memorandum on restrictions on insider trading does not limit the duties that may impose restrictions on trading to those clarified in the STOCK Act.³³³ The Memorandum counsels that some securities trading may violate federal government ethics standards, Senate nondisclosure rules, and Senate conflict-of-interest rules. It suggests, however, that violation of *these* standards and rules might be grounds for action by the Committee.³³⁴

Consequently, there might be a lingering concern that a court (such as the Second Circuit, which has required *fiduciary-type* duty of confidentiality) might hold that the language of the STOCK Act might establish the ethical obligations of Congress and its employees under Congressional rules of practice. The language of the STOCK Act, however, is insufficient to establish liability under the ’34 Act. Of course, anything can happen, but these scenarios seem unlikely as a practical matter. Both the preamble of the STOCK Act, which states its purpose, as well as section 4, which amends section 21A of the ’34 Act to provide that members of Congress and their staffers have a duty of “trust and confidence” “for purposes of the insider trading prohibitions,” indicate that, despite its inartful drafting, the STOCK Act was intended to confirm that members of Congress and their staffers *do* have the appropriate type of duty to impose liability. The more practical problem with the legislation is that it does not clearly establish how the other elements of the *O’Hagan* text will be met.

To reiterate, the Supreme Court has held that a breach of a fiduciary or equivalent duty *per se* does not constitute securities fraud.³³⁵ Fraud requires that the fiduciary breach a duty to speak, and ties this duty to the taking of proprietary information. Further, this fraud is only securities fraud if the information stolen is of a sort ordinarily used to reap risk-free profits through the trading of securities.³³⁶

³³² See Stop Trading on Congressional Knowledge Act of 2012 (STOCK Act), Pub. L. No. 112-105, 126 Stat. 291 (2012).

³³³ Oddly, the Memorandum speaks of a duty of “trust *or* confidence,” echoing the disjunctive language of Rules 10b5-1 and 10b5-2, rather than the conjunctive language of the Act. Memorandum from the Senate Comm. on Ethics, *Restrictions on Insider Trading Under Securities Laws and Ethics Rules 2* (Dec. 4, 2012), available at http://www.ethics.senate.gov/public/index.cfm/files/serve?File_id=8c923399-2dc0-4ef6-a0d2-9ef564fc7038 [hereinafter *Senate Memorandum*].

³³⁴ *Id.* at 3.

³³⁵ See *supra* Part II.B.

³³⁶ See *supra* Part II.E.

Ironically, therefore, it could be that the most important legacy of the STOCK Act will be the law of outsider trading applicable to *other* defendants. That is, by choosing to track the language of Rule 10b5-2, rather than that of *O'Hagan* or *Chestman*, Congress may be deemed to have implicitly endorsed this rule with respect to non-members of Congress or their staffers.

B. Non-Concerns

Before moving on to some potentially legitimate concerns about the applications of the STOCK Act, let me dispose of the non-issues: (i) trading by family members and (ii) non-deceitful trading.

1. Trading By Family Members

Shortly after the STOCK Act's enactment, CNN published an exclusive "uncover[ing] that the law ... isn't exactly as advertised. A loophole could still allow family members of some lawmakers to profit from inside information."³³⁷ The article quotes then-Senator Scott Brown: "Say I find out some information, I tell my wife and she goes and trades on it, what's the difference?"³³⁸

This "loophole" seems to have been as mythical as the imaginary congressional exemption from insider-trading law that supposedly existed before the STOCK Act. If a trade done directly by a member of Congress or their staff would be unlawful, then the same trade done by a family member should also be unlawful in almost all cases under one of two theories.

First, insider-trading law governs the trading of securities held beneficially, as well as of record. Beneficial ownership is defined as the right to control, directly or indirectly, the voting or disposition of securities.³³⁹ This obviously must be the case if for no other reason that few individuals own securities in their own name, but own them indirectly through brokers, banks depositories and other "security intermediaries," to use the terminology of the Uniform Commercial Code.³⁴⁰ Consequently, a member of Congress cannot get around the securities laws merely by transferring securities into the name of a spouse, child, or parent, if the member retains the ability—even informally—to direct the disposition of the securities.

³³⁷ Deirdre Walsh & Dana Bash, *CNN Exclusive: Congressional Insider Trading Ban Might Not Apply to Families*, CNN (July 19, 2012, 10:09 PM), <http://www.cnn.com/2012/07/19/politics/stock-act-loophole/>.

³³⁸ *Id.* (internal quotation marks omitted).

³³⁹ 17 C.F.R. § 240.13d-3 (2014).

³⁴⁰ U.C.C. § 8-102(a)(14) (1994).

Second, even in the unusual case where securities hypothetically owned by Senator Brown's wife were also not deemed to be beneficially owned by him, if the wife traded the shares on the basis of material, non-public information acquired by Senator Brown in violation of his duties, the tipping rules established by *Dirks v. SEC* would apply.³⁴¹ Thus, Senator Brown's "loophole" is much ado about nothing.

The tipping rule, like the beneficial-ownership rule, is designed to prevent a covered person from doing indirectly what he cannot do directly. In order to be unlawful, the tip must itself constitute a violation of the tipper's duty to the source.³⁴² To constitute a violation, the tipper must intend to receive some benefit from the tip.³⁴³ The simplest example of this would be if the tipper expected that the tippee would either share some of her trading profits or would perform some other *quid pro quo*. But the Supreme Court has also expressly stated that a benefit includes giving a gift to a relative.³⁴⁴ Consequently, a member of Congress or their staffers who disclosed non-public information to a family member would almost certainly be liable as a tipper.³⁴⁵

What was a more reasonable concern in the CNN report was that the *draft* guidelines prepared by the House Ethics Committee (but not the Senate Committee on Ethics) initially took the position that provisions of the STOCK Act relating to prompt reporting of securities' trades (in contrast to annual financial disclosures) did not cover trades by family members.³⁴⁶

³⁴¹ *Dirks v. SEC*, 463 U.S. 646 (1983).

³⁴² *Dirks* involved the issue of what was an unlawful tip from a classic insider. In *United States v. Falcone*, 257 F.3d 226 (2d Cir. 2001), the Second Circuit held that the elements of tipper liability might differ in the misappropriation context. This dispute is beyond the scope of this Article.

³⁴³ *Dirks*, 463 U.S. at 662–64.

³⁴⁴ *Id.* at 664.

³⁴⁵ Moreover, in most cases, as an empirical matter, the family member would also be liable as a tippee. Based on the principle that mere possession of nonpublic information cannot impose duties on securities' traders, for a tippee to have liability for insider trading she must know or have reason to know that the tipper violated his duties. *Id.* at 660. One might be able to hypothesize extravagant facts in which a family member might genuinely not understand that a Congressman's disclosure of nonpublic information relevant to trading securities is a violation of a duty of confidentiality—although it would probably be rare as an empirical matter. In any event, given the existence of the STOCK Act, the SEC might be able successfully to argue that the tippee had reasonable grounds to believe there was a violation.

³⁴⁶ Memorandum from United States H.R. Comm. on Ethics to All House Members, Officers, and Employees: Periodic Reporting of Personal Financial Transactions Pursuant to the STOCK Act (June 7, 2012), <http://ethics.house.gov/sites/ethics.house.gov/files/ptr%20pink%20sheet.pdf>. The executive branch's Office of Government Ethics also took this position. See Walsh & Bash, *supra* note 337.

I have suggested that the shaming effect of these might have a greater effect on discouraging congressional trading than its insider-trading provisions *per se*. For it to be effective, however, it would be preferable that it covers trades of beneficially owned securities. In any event, after the CNN report aired, Congress quickly amended the STOCK Act to clarify that the periodic filing requirements did apply to transactions in securities owned by a filer's spouse and dependent children.³⁴⁷

2. *The Brazen Representative or Senator: Disclosure and Permission to Trade*

As discussed, one surprising aspect of the Supreme Court's property analysis is that, under the misappropriation theory, trading in securities on the basis of material, nonpublic information is lawful if the recipient of the information discloses his intent to trade to the source or if the source gives him permission to trade.³⁴⁸ Consequently, because the STOCK Act does not directly prohibit trading by any party but merely alludes to the misappropriation theory, a member of Congress might be off the hook if he publicly announced his intent to trade on congressional information.³⁴⁹ Alternately, Congress (or perhaps an appropriate Committee) could grant her permission to trade.

Even if this were the case, these events would be so scandalous that I do not think that they pose much of a risk. Furthermore, even in the extremely unlikely event that Congress would grant such permission, the Congress member would still be subject to the embarrassing reporting requirements the Act apparently designed to discourage unseemly behavior.

C. *Property of Congress*

Congress's decision not to define unlawful trading but merely to allude indirectly to the misappropriation theory raises the issue of if or when Congress, the United States or the people have a *proprietary* right in nonpublic information that could be misappropriated. This is important because of the Supreme Court's insistence that section 10(b) does not prohibit mere breaches

³⁴⁷ STOCK Act, Pub. L. No. 112-173, 126 Stat. 1310 (2012). *See also* Walsh & Bash, *supra* note 337. The House Ethics Committee subsequently revised its memorandum to comply with this change. *See* Memorandum from the United States H.R. Comm. on Ethics to All House Members, Officers, and Employees: Periodic Reporting of Personal Financial Transactions Pursuant to the STOCK Act, as amended (Aug. 17, 2012), <http://ethics.house.gov/sites/ethics.house.gov/files/PTR%20amended%20pink%20sheet.pdf>.

³⁴⁸ *See supra* Part I.C.2.b.

³⁴⁹ I am leaving aside the question as to the timing of this disclosure. *See supra* Part II.

of fiduciary duties, but only the fraudulent misappropriation of nonpublic information.³⁵⁰ The difficulty of applying this element in the congressional context illustrates the absurdity of the fact that insider trading law has developed into a *de facto* federal common law of intellectual property.

The Senate Ethics Committee Memorandum reflects the uncertainty of the law. It states first that securities laws prohibit the “misappropriation of information in violation of a duty” and that members and staff “*could* violate” Rule 10b-5 if they “purchase[d] securities based on information obtained in the course of their official duties, or derived from their Senate position, if that information was material and nonpublic and they breached the duty of trust and confidence”³⁵¹ I do not know whether the uncertainty expressed in this language is intentional, but I would note that the Memorandum otherwise seems very carefully worded. Furthermore, it emphasizes that much congressional trading and even tipping will continue to be lawful:

[I]nadvertently sharing information in good faith, without the intent to benefit from such disclosure, is not enough to violate securities laws. Moreover, while Senators and staff are prohibited from using *nonpublic* information for making a trade, a great deal of Congressional work is conducted on the *public* record or in the public realm during committee hearings and markups, floor activity, and speeches.³⁵²

One of the few post-*O’Hagan* cases I have been able to find (other than the civil action against the FDA scientist that has not yet come to trial), in which a misappropriation case has been brought involving government information, is *United States v. Nothern*.³⁵³ The DOJ alleged that the defendant, an officer at an investment management firm, traded as a tippee on the not-yet public announcement by the Treasury Department that it was suspending the sale of 30-year Treasury Bonds. The alleged tipper, Peter Davis, was a consultant hired by Goldman Sachs who attended a closed Treasury press conference. Davis was told that attendees must keep the information strictly confidential until an embargo expired later that day.³⁵⁴ The defendant brought a motion to dismiss on the grounds that the government alleged merely that the tipper had, at most, entered into a contractual confidentiality agreement

³⁵⁰ See *supra* notes 54–56.

³⁵¹ *Senate Memorandum*, *supra* note 333 (emphasis added).

³⁵² *Id.*

³⁵³ *United States v. Nothern*, 598 F. Supp. 2d 167 (D. Mass. 2009). In related litigation, Davis, the tipper, and John Youngdahl, another tippee and an economist at Goldman, pled guilty to criminal insider trading penalties. The defendants and Goldman Sachs also settled SEC enforcement actions resulting in injunctions, monetary penalties, censure and disgorgement. See Nagy, *Fiduciary Principles*, *supra* note 29, at 1363–64.

³⁵⁴ 598 F. Supp. 2d at 170.

but did not allege that he had the fiduciary-type duty required under the misappropriation theory.³⁵⁵ Rejecting the Second Circuit's holding in *Chestman*, the District Court for Massachusetts refused the motion on the grounds that a contractual duty was sufficiently "similar" to a fiduciary duty of confidentiality to satisfy the elements of *O'Hagan*.³⁵⁶ Among the issues *not* raised by the defendant, however, was whether the Treasury had a proprietary interest in the information about its intent to suspend sales such that it was fraudulently deprived of its exclusive use of this property.

One can also imagine types of confidential, nonpublic information that a representative or senator might learn in her official capacity that would *not* be proprietary to Congress. An example would be nonpublic industry or company-specific information supplied by constituents or lobbyists in order to shape proposed legislation. If anyone owns this information, it would be the source who would have the right to use it for its own purposes. The STOCK Act provides that the member of Congress would have a duty of confidence to Congress, the government, and the people, with respect to this information, because he gained it through the performance of her official duties. Would it be unlawful for the member of Congress to use this information to trade the source's securities *if* the source gave her permission to do so?

Another problem of applying the Supreme Court's property-based analysis to congressional trading is the STOCK Act's strange proviso that the duty arising from a relationship of trust and confidence only exists for the purpose of the insider trading rules. The negative pregnant of the proviso is that members of Congress and their staffers have the right to use nonpublic information in all circumstances other than in the trading of stock. Presumably, this is to ensure that a senator could disclose this information to the press or potential voters, or that a representative could discuss information with constituents, trade groups, lobbyists, or other parties who might have interest in potential legislation. As stated in the senate Ethics Committee Memorandum, the STOCK Act "is not intended ... to chill legitimate communications made in good faith between public officials and their constituents, inhibit government transparency, or otherwise hinder the dissemination of public information about government activities."³⁵⁷ Presumably, the only limitation on this is if a representative gave nonpublic information to a donor in the expectation of a *quid pro quo*, in which case the tipping rules of *Dirks* might come into play as the Memorandum implies.³⁵⁸ The Memorandum also warns

³⁵⁵ *Id.* at 170–71.

³⁵⁶ *Id.* at 174–75 (noting that in a parenthetical in *O'Hagan*, Justice Ginsburg used the formulation "some fiduciary, contractual, or similar obligation").

³⁵⁷ *Senate Memorandum, supra* note 333, at 1.

³⁵⁸ *Id.* at 2.

that disclosure of confidential information “received in a closed, nonpublic hearing; information gathered during the confidential stages of a committee investigation; and classified national security information” might violate Senate Rule 29.5, might subject a senator to expulsion or a staffer to dismissal, and might be grounds for a sanction such as contempt.³⁵⁹

But does this also suggest that Congress, the government, and the people in fact do *not* have a proprietary interest in the information (understood as the right to *exclusive* use)? That is, Congress seems to be *disclaiming* ownership of the information.

Perhaps one could strain and answer that *if* Congress owned this information, *then* it follows that it also has the right to alienate it any way it sees fit, including giving a senator the right to use it for any purpose except one. Obviously, limitations in *use* are contained in intellectual property licenses all the time. The problem with this argument is that under trade secret law, one only has proprietary rights in information so long as one takes efforts to protect its secrecy. It would seem, therefore, that by giving people the right to use and *disclose* information generally, with only one exception, Congress would lose its proprietary right in the information. In any event, this illustrates the awkwardness of trying to shoehorn a concern about congressional integrity into a property-based anti-fraud regime.

D. Information “Of a Sort Ordinarily Used” in Trading Securities

Perhaps the most problematic element of an SEC civil action, a contemporaneous trader’s private right of action, or a DOJ prosecution of a member of Congress or its staffers under the ’34 Act, would be the limitation announced by the majority in *O’Hagan* that the material, nonpublic information be *of a sort ordinarily* used in the trading of securities to reap risk-free profits. This is necessary to satisfy the element of section 10(b) and Rule 10b-5 that the fraud be “in connection with” the purchase or sale of securities. As discussed above, Justice Thomas, correctly in my opinion, chastened Justice Ginsburg for not explaining what this might mean.³⁶⁰ She assumed the very facts that she says needs to be proven. The case law under the misappropriation theory is not much more helpful in giving meaning to this limitation. Indeed, it is not clear what remains of this element.

1. Specific Information

A student note by Bud Jerke³⁶¹ on the related subject of trading on the basis of political intelligence provides the following anecdote: On November 16,

³⁵⁹ *Id.* at 3.

³⁶⁰ *See supra* Part II.D.

³⁶¹ *See Jerke, supra* note 324.

2005, Senate Majority Leader William Frist announced that there would be a Senate vote on an asbestos trust fund bill that had been languishing in Congress for years. The timing of this announcement had, apparently, been kept secret. Nevertheless, the day before the announcement saw significant increases in trading in three companies, which were defendants in asbestos litigation.³⁶² This is evidence that some persons did *in fact* trade on the basis of this information. It was also apparently true that a previous push to pass this legislation caused the prices of the stock of these issuers to increase, suggesting that information about the potential legislation was material to investors in asbestos defendants. Does this make it information of a sort that is *ordinarily* traded on to make risk-free profits? Certainly it has other financial uses for those and other asbestos defendants, as well as asbestos plaintiffs and their respective attorneys, and also their creditors who are trying to make decisions in light of the on-going information. It might also have financial implications for other companies who are or might be the target of mass tort litigation and, perhaps, for the tort law bar as a whole. Once again, this raises the question as to what the word “ordinarily” is supposed to mean.

Another group of students led by Matthew Barbabella, in discussing economic arguments for and against the regulation of congressional trading, poses the following hypothetical:

Imagine you are a financially savvy United States congressional representative. In a week, you intend to announce the proposal of an appropriations bill that will award a huge, no-bid contract to a publicly traded energy company. You expect the news to sharply increase the price of that company’s stock. Enticed by this foolproof investment opportunity, you decide to purchase shares of stock in the company that will be receiving the contract....³⁶³

At first blush, as this information, according to the hypo, pertains to firm-specific financial conditions of a specific company and is expected to “sharply increase” its stock price, it would seem to be an easier case of information “of a sort ordinarily used” in purchasing that stock. On closer examination, however, there are other financial uses of the information. For example, if the member of Congress were a little smarter, he could have shorted the stock of companies that did not receive the contract.

Jerke lists a number of questionable trades by specific members of Congress.³⁶⁴ For example, according to a study by Professor Gregory Boller:

³⁶² *Id.* at 1454–56 (“Fueled primarily by hedge funds, K Street lobbyists (including lawyer-lobbyists at several prominent law firms) have cultivated the lucrative niche of ferreting out little-known political information and funneling it to Wall Street.”).

³⁶³ Barbabella et al., *supra* note 4, at 200.

³⁶⁴ *See* Jerke, *supra* note 324, at 1461–67.

On Feb. 22, 1991, then-Sen. Bentsen purchased stock (reported as between \$1,000 and \$15,000 in value) in food and dairy company Morningstar Foods. Four days later, an amendment to the National School Lunch Act was introduced in the Senate to diversify milk choices for lunch programs. On Dec. 23, 1991, Bentsen sold his stock. Eight days later, Morningstar came under a Justice Department probe into bid-rigging to sell milk in public schools.³⁶⁵

He concludes that “this anecdote suggests that former Senator Bentsen knew not only when to purchase stock in a company that would benefit from legislation but also when to sell stock that would be detrimentally affected by a governmental investigation.”³⁶⁶

Once again (and assuming, as Jerke apparently does, that the price of the issuer’s stock was affected by these two events and that the Senator learned of the DOJ probe through his official capacity), there is a question as to whether these were information “of a sort ordinarily used” in the trading of Morningstar stock. And, once again, it could also be used to invest in the stock of rival dairies who would now be able to bid for government contracts, or even in companies that provide alternate beverages or foods to schools.

The closest reported case alleging unlawful trading by a governmental official on governmental information is the pre-*O’Hagan* case of *United States v. Bryan*.³⁶⁷ The West Virginia Lottery Commission Director rigged the granting of valuable contracts to favored bidders, and purchased shares in the winning company prior to the announcement of the award. The Fourth Circuit upheld his conviction under the Federal Mail and Wire Fraud statutes on the grounds that he fraudulently deprived the citizens of the state of “their right to [receive] his honest services,” relying in part on the Supreme Court’s decision in *Carpenter*.³⁶⁸ The court, however, overturned his conviction for

³⁶⁵ See *id.* at 1463 (quoting Joy Ward, *Taking Stock in Congress*, MOTHER JONES, Sept.–Oct. 1995, at 16 (summarizing Boller’s findings)).

³⁶⁶ *Id.*

³⁶⁷ According to the court:

[I]n principle, if not in reality, these courts would be obliged to find liability in the case of simple theft by an employee, even where no fiduciary duty has been breached, for the *raison d’etre* of the misappropriation theory in fact is concern over “the unfairness inherent in trading on [stolen] information.”

United States v. Bryan, 58 F.3d 933, 951 (4th Cir. 1995) (quoting *Chiarella v. United States*, 445 U.S. 222, 241 (1980) (Burger, C.J., dissenting) (citation omitted)). It states further: “we tread cautiously in extending the misappropriation theory to new relationships, lest our efforts to construe Rule 10b-5 lose method and predictability, taking over ‘the whole corporate universe.’” *Id.* at 959 (quoting *United States v. Chiarella*, 588 F.2d 1358, 1377 (2d Cir. 1978) (Meskill, J., dissenting) (quoting *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 480 (1977)), *rev’d*, 445 U.S. 222 (1980)).

³⁶⁸ 58 F.3d at 943.

insider trading under section 10(b) and Rule 10b-5 because it rejected the misappropriation theory:

In contravention of this established principle, the misappropriation theory authorizes criminal conviction for simple breaches of fiduciary duty and similar relationships of trust and confidence, whether or not the breaches entail deception within the meaning of section 10(b) and whether or not the parties wronged by the breaches were purchasers or sellers of securities, or otherwise connected with or interested in the purchase or sale of securities.³⁶⁹

In a long and detailed examination of the Supreme Court's pre-*O'Hagan* 10b-5 jurisprudence, the court found that securities fraud was limited to deception of participants in the securities markets and could not be extended to a "federal common law governing and protecting any and all trust relationships."³⁷⁰ Nagy argues that today, after *O'Hagan*, there is "no question" that the Director or another government officer could be convicted for insider trading on similar facts *even before* passage of the STOCK Act.³⁷¹ I do not believe that this is so clear if the requisite duty under the misappropriation theory must be fiduciary or its functional equivalent.

The Fourth Circuit did *not* find that the Director had a *fiduciary* duty to the state regarding this information. Indeed, it strongly implied that he had *no such duty*. It based its decision on the mail-fraud conviction based on the fact that he had violated an oath to execute his duties in an "honest, legal, and efficient manner" and avoid conflicts of interest.³⁷² However, it rejected the government's argument that he committed *securities* fraud when he breached "his duty of confidentiality and his statutory obligation to refrain from using his position for personal gain" because of its concern about the uncertainty that would be caused by finding new, broad fiduciary duties.³⁷³ "As the Second Circuit noted in *Chestman*, '[t]he existence of fiduciary duties in ... common law settings' outside the shareholder relations context 'is anything but clear.'"³⁷⁴ It is not clear whether *Bryan* would be decided differently today under the Supreme Court's formulation of the misappropriation theory.

2. General Market Information

The examples that these note writers discuss are analogous to insider trading cases that have been brought against non-congressional actors because they involve firm-specific, nonpublic information used to trade in

³⁶⁹ *Id.* at 944.

³⁷⁰ *Id.* at 945–50.

³⁷¹ Nagy, *Entrustment*, *supra* note 2, at 1154.

³⁷² 58 F.3d at 941 n.2.

³⁷³ *Id.* at 945 (citation omitted).

³⁷⁴ *Id.* at 951.

securities of that firm. Once one moves beyond legislation intended to affect a single issuer or industry, the application of the STOCK Act becomes more problematical.

For example, soon after *60 Minutes* ran its exposé on congressional trading, Roger Parloff published a denunciation in *Fortune* that showed unusual sophistication in his understanding of the law, going so far as to cite the debate between Nagy and Bainbridge.³⁷⁵ He, however, gives the following example of the “problem”:

During the *60 Minutes* segment, Hoover Institute fellow Peter Schweizer (author of the recent book *Throw Them All Out*) asserted that in mid-September 2008, Alabama representative Spencer Bachus, then the ranking member of the House Financial Services Committee, attended closed-door meetings at which Treasury Secretary Hank Paulson and Federal Reserve chairman Ben Bernanke warned congressional leaders that a global financial meltdown was imminent. “Literally the next day,” according to the Schweizer, Bachus bought stock options in funds that would make money if the market went down.³⁷⁶

If these types of broad, *economy-wide* information were to be considered “of a sort,” then the STOCK Act would seem to prohibit any and all trading in publicly issued securities by Congress and its staff.³⁷⁷ If this was Congress’s intent, would it not have been simpler merely to provide so directly by requiring all members to place their investments in blind trusts, as many of them do already?

This example also raises the issue as to what it means for information to be nonpublic. Except for, perhaps, last-minute amendments made on the floor, the possibilities of much legislation have been discussed both publicly and privately, within and outside of Congress, by large numbers of members of Congress and their staff, lobbyists, pundits, and the like. As such, would the “nonpublic” part of the information be the likelihood that a bill would actually be introduced or would pass both Houses and be signed by

³⁷⁵ Roger Parloff, *It’s Time To Ban Insider Trading by Congress*, FORTUNE (Nov. 18, 2011, 10:18 AM), <http://finance.fortune.cnn.com/2011/11/18/insider-trading-congress/>.

³⁷⁶ *Id.*

³⁷⁷ A reporter for the *Philadelphia Inquirer* speculated that this might be a reason that the SEC has declined to investigate Congressional trading.

Members of Congress are not like regulators, who typically focus on a single sector of the economy; they make laws for everyone. To prevent any conflicts of interest, members who invest would have to abstain from most congressional business, or they would have to be prevented from buying virtually any stocks, said an individual familiar with Congress and its relations with business.

DiStefano, *supra* note 6.

the President?³⁷⁸ As George Canellos, co-chief of the SEC's enforcement division has said, "when it comes to market-moving information coming from Congress 'the lines aren't quite as bright and the opportunities for arguments by the defense [in an insider trading action] are greater.'"³⁷⁹

In the specific example cited by Parloff, when Representative Bachus and his colleagues met with Secretary Paulson and Chairman Bernanke, it was hardly news that the global economy was in a crisis. It was well known that the Treasury and the Fed were desperately lobbying Congress to approve the Troubled Assets Relief Program, or TARP,³⁸⁰ after Lehman Brothers had filed for bankruptcy, the government had taken over AIG, a major money-market fund had broken the buck, and the markets were panicking.³⁸¹

As already discussed, the Senate Memorandum already concludes that much congressional work should be deemed public.³⁸² The House Memorandum, however, cautions:

Members and employees may obtain material nonpublic information about a public company or economic sector (e.g., energy, telecommunications, or healthcare) during the course of their official duties or in their personal capacity from family, friends, acquaintances, or from their own involvement with a company. If the Member or employee chooses to trade on this information, they *may* have engaged in insider trading."³⁸³

³⁷⁸ This raises yet another issue that has plagued trade secret jurisprudence. Under Sec. 10(b) and Rule 10b-5, misstatements and omissions are only actionable if they involve *material* information. Pending legislation would also seem to be "contingent" information—that is, it may or may not ever be adopted. In *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), the Supreme Court held that whether or not a contingent event is "material" within the meaning of the securities laws is determined by balancing its probability against its magnitude. That is, an event that, if it were to occur, would have an extremely large effect on an issuer might be material even if it were relatively unlikely, but even a very likely event might not be material if the expected effect were small. *Id.* at 238-41.

When would pending legislation become material on this standard? The problem is that it is likely that the greater *both* the magnitude of the effect and the probability of enactment, also the more likely that both would be widely known. That is, the more material legislation becomes, more likely that it is no longer nonpublic.

³⁷⁹ Brody Mullins, Jean Eaglesham & Devlin Barrett, *Probe of How U.S. Agency's Medicare Move Reached Investors Hits Wall*, WALL ST. J. (Nov. 21, 2013, 11:50 AM), <http://online.wsj.com/news/articles/SB10001424052702304607104579210320473074320>.

³⁸⁰ Emergency Economic Stabilization Act of 2008, Pub. L. 110-343, 122 Stat. 3765 (codified as amended at 12 U.S.C. §§ 5201–5261 (2008)).

³⁸¹ Notoriously, at one of the meetings with Congressional representatives Secretary Paulson stated: "If [TARP] doesn't pass, then heaven help us all." Deborah Solomon et al., *Shock Forced Paulson's Hand*, WALL ST. J. (Sept. 20, 2008, 11:59 PM), <http://online.wsj.com/article/SB122186563104158747.html> (internal quotation marks omitted).

³⁸² *Senate Memorandum*, *supra* note 333, at 1.

³⁸³ *Memorandum, New Ethics Requirements*, *supra* note 277, at 6 (emphasis added).

These perhaps insuperable line-drawing problems are probably one reason why a proposed provision limiting “political intelligence”³⁸⁴ was deleted from the STOCK Act before passage and referred to further study.³⁸⁵

CONCLUSION

The STOCK Act was enacted to address a public relations problem, not a real legal problem. It “closed” a non-existent loophole that supposedly exempted Congress and its staff from the federal securities laws. It did not, unfortunately, address very real legal and jurisprudential problems. The Supreme Court’s interpretation of insider trading law, which is based on prohibiting fraud and protecting intellectual property, is unclear and poorly suited to the concerns of market and government integrity. The STOCK Act does little to clarify when congressional trading specifically would be unlawful, let alone attempt to define insider trading generally. Its effects are likely to be marginal. Its requirement that members and staff promptly report securities trades may lead to more transparency. Its use of the language “duty of trust and confidence” might be interpreted as endorsing the language of Rules 10b5-1 and 2 applicable to other traders. I doubt that it will lead to significant SEC or DOJ litigation.

³⁸⁴ Political intelligence is information gleaned by consultants from conversations with Congress, lobbyists, etc. about upcoming legislation that is then sold to clients. Brody Mullins & Susan Pulliam, *Buying ‘Political Intelligence’ Can Pay Off Big for Wall Street*, WALL ST. J., Jan. 18, 2013, at A1.

³⁸⁵ The STOCK Act directs the Comptroller General to submit “a report on the role of political intelligence in the financial markets” within twelve months of the enactment of the act. Stop Trading on Congressional Knowledge Act of 2012 (STOCK Act), Pub. L. No. 112-105, 126 Stat. 291 (2012).