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SEC RULE 14e-3 IN THE WAKE OF *UNITED STATES v. O'HAGAN*: PROPER PROPHYLACTIC SCOPE AND THE FUTURE OF WAREHOUSING

Not surprisingly, the Supreme Court's June 25, 1997, decision in *United States v. O'Hagan*,¹ concerning the controversial legal topics of insider trading and securities regulation,² elicited a wide variety of reactions.³ Somewhat unexpected, however, was the legal community's focus on the Court's ruling in regard to SEC Rule 10b-5 and the judicially-created "misappropriation

1. 521 U.S. 642 (1997). In *O'Hagan*, the Supreme Court decided the broad legal issues involved and remanded the case to the Eighth Circuit for a ruling consistent with the guidelines established by the Court. See *United States v. O'Hagan*, 139 F.3d 641 (8th Cir. 1998), *on remand from* 521 U.S. 642 (1997).

2. One commentator, noting that "[h]ardly a month goes by without an article on insider trading appearing in one legal journal or another," further points out that the topic is controversial because so many issues remain open to a "great deal of debate." Paula J. Dalley, *From Horse Trading to Insider Trading: The Historical Antecedents of the Insider Trading Debate*, 39 WM. & MARY L. REV. 1289, 1293 (1998).

3. See, e.g., Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 VA. L. REV. 153, 228 (1998) ("The misappropriation theory is appealing precisely because it comports with our collective sense of moral approbation of people breaching a position of trust for their personal and financial advantage."); Harvey L. Pitt et al., *Misappropriating Certainty from the Securities Markets: A Practitioner's Primer on the O'Hagan Decision*, 2 N.C. BANKING INST. 71, 71 (1998) ("The impact of this outcome . . . extends far beyond the fortunes of one defendant. The manner in which the government prevailed in *O'Hagan* will have significant day-to-day implications"); Carol B. Swanson, *Reinventing Insider Trading: The Supreme Court Misappropriates the Misappropriation Theory*, 32 WAKE FOREST L. REV. 1157, 1158 (1997) ("By adding another flawed piece to the already shaky structure of insider trading case precedent, the Court risks total collapse."); Dominic Bencivenga, *The Right Set of Facts: 'O'Hagan' Court Affirms SEC Rule-Making Power*, N.Y.L.J., July 3, 1997, at 3 ("[The decision is] going to have far ranging ramifications in terms of future power given to the SEC.") (quoting securities lawyer Harvey L. Pitt); Michael Prozan, *Supreme Court Tries to Clear Up the Ins and Outs of Insider Trading*, BUS. J.-SAN JOSE, Oct. 6, 1997, at 58 ("Lawyers may disagree over the technicalities of . . . *O'Hagan*, but it benefits everyone by defining certain areas of insider trading."); Anne Kates Smith, *Betrayers of Trust: Who's An Inside Trader*, U.S. NEWS & WORLD REP., July 7, 1997, at 72, 75 ("The Supreme Court's decision is a powerful boost to the government's enforcement power").

theory" of insider trading liability.⁴ Although the predecision circuit split⁵ concerning the misappropriation theory's validity as a foundation for SEC Rule 10b-5 securities fraud liability certainly justified the significant attention paid to it within both the Court's analysis and the resulting legal commentary, an unfortunate repercussion of the attention seems to be that an

4. See *O'Hagan*, 521 U.S. at 650-66 (ruling that criminal liability under section 10(b) of the Securities Exchange Act of 1934 may be predicated upon the "misappropriation theory" of inside information; as such, the SEC may prohibit trading practices involving confidential information even though the transactions may lack the traditional direct breach of fiduciary duty required as an element of common-law fraud). As a result of the *O'Hagan* decision, "fraud on the source" is now the operative standard, and 'fraud on the trading partner' need not be proved." John C. Coffee, Jr., *Outsider Trading After O'Hagan*, CORP. COUNS., Dec. 1997, at 6; see also Elliot J. Weiss, *United States v. O'Hagan: Pragmatism Returns to the Law of Insider Trading*, 23 J. CORP. L. 395, 423 (1998) ("The misappropriation theory protects the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect that corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders." (emphasis added) (citing Petitioner's Brief, *United States v. O'Hagan*, 521 U.S. 642 (1997) (No. 96-842), available in 1997 WL 86306)).

For a history of the development of the misappropriation theory of insider trading liability, see David Cowan Bayne, S.J., *Insider Trading: The Demise of the Misappropriation Theory—And Thereafter*, 41 ST. LOUIS U. L.J. 625 (1997); Painter et al., *supra* note 3; Steven R. Salbu, *The Misappropriation Theory of Insider Trading: A Legal, Economic, and Ethical Analysis*, 15 HARV. J.L. & PUB. POL'Y 223 (1992); Timothy Sullivan, Comment, *We're Still Against Fraud, Aren't We?* *United States v. O'Hagan: Trimming the Oak in the Wrong Season*, 71 ST. JOHN'S L. REV. 197 (1997).

5. Prior to the *O'Hagan* decision, several courts of appeals had upheld the validity of applying the misappropriation theory of insider trading to Rule 10b-5 violations, including the Second Circuit, see *United States v. Chestman*, 947 F.2d 551, 566-67 (2d Cir. 1991) (en banc), the Third Circuit, see *Rothberg v. Rosenbloom*, 771 F.2d 818, 822-23 (3d Cir. 1985), the Seventh Circuit, see *SEC v. Maio*, 51 F.3d 623, 630-34 (7th Cir. 1995), the Ninth Circuit, see *SEC v. Clark*, 915 F.2d 439, 442-53 (9th Cir. 1990), and the Tenth Circuit, see *SEC v. Peters*, 978 F.2d 1162, 1165-67 (10th Cir. 1992). In contrast, its validity had been rejected in the Eighth Circuit, see *United States v. O'Hagan*, 92 F.3d 612, 615-22 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997), and the Fourth Circuit, see *United States v. Bryan*, 58 F.3d 933, 943-60 (4th Cir. 1995).

For an analysis of the rationale underlying the Fourth and Eighth Circuits' decisions to reject the misappropriation theory, see Swanson, *supra* note 3, at 1175-91, Timothy J. Horman, Comment, *In Defense of United States v. Bryan: Why the Misappropriation Theory Is Indefensible*, 64 FORDHAM L. REV. 2455, 2485-91 (1996) (discussing the Fourth Circuit's rejection of the misappropriation theory), and Sean P. Leuba, Note, *The Fourth Circuit Breaks Ranks in United States v. Bryan: Finally, A Repudiation of the Misappropriation Theory*, 53 WASH. & LEE L. REV. 1143, 1198-207 (1996) (same).

equally important aspect of the *O'Hagan* decision has received inadequate treatment.⁶

Specifically, legal scholars have neglected the Court's ruling with respect to SEC Rule 14e-3 and its prohibition against fraudulent trading in connection with a tender offer.⁷ Although the *O'Hagan* Court's brief analysis of Rule 14e-3⁸ settled several legal questions surrounding the rule's scope and validity,⁹ signif-

6. This aspect of the *O'Hagan* decision—concerning SEC Rule 14e-3—has not, however, been neglected by all legal commentators. See, e.g., *High Court Insider Trading Decision May Leave Question*, WALL ST. LETTER, June 30, 1997, available in 1997 WL 12203150; Joseph McLaughlin, *O'Hagan: Some Answers, More Questions*, N.Y.L.J., July 1, 1997, at 1.

7. Interestingly, the term "tender offer" is neither defined within the Williams Act, Pub. L. No. 90-439, 82 Stat. 454, 457 (1968) (codified as amended at 15 U.S.C. § 78n(e) (1994)), nor within any of the SEC's rules promulgated thereunder. See Dale A. Oesterle, *The Rise and Fall of Street Sweep Takeovers*, 1989 DUKE L.J. 202, 217-33. The courts typically define a "tender offer" broadly, aided by an eight-factor test developed in *Wellman v. Dickinson*, 475 F. Supp. 783, 823-24 (S.D.N.Y. 1979) (holding a tender offer made without a preacquisition filing to be a violation of the Williams Act).

Despite the relative ambiguity, a useful working definition of a "tender offer" is any "public invitation to . . . shareholders of the target corporation to tender their shares." ROBERT W. HAMILTON, CASES AND MATERIALS ON CORPORATIONS 1139 (5th ed. 1994). Initiation of a tender offer is predicated largely on a tactical consideration that stems from the desire of the bidder to gain effective control over a target corporation. See LEWIS D. SOLOMON & ALAN R. PALMITER, CORPORATIONS: EXAMPLES AND EXPLANATIONS § 39.2, at 580-81 (2d ed. 1994). This consideration has been generalized as follows:

Seeking control through open market purchases is problematic – rarely will enough shareholders be willing to sell at market for a bidder to acquire a control block. A tender offer forces the question. The bidder greatly increases its chances of acquiring a control block by publicly offering to buy a specified number of tendered shares during a specified period at a premium over prevailing market prices. A tender offer operates much like a retailer's "week-end clearance sale at never again prices."

Id. at 580.

8. See *O'Hagan*, 521 U.S. at 666-77.

9. With respect to Rule 14e-3, the Court in *O'Hagan* answered, in the affirmative, the question of whether the SEC possessed sufficient authority to promulgate Rule 14e-3, and additionally, whether the SEC could interpret the rule as prohibiting the type of tender offer securities trading activity presented by the particular facts of the case. See *id.*; see also Richard M. Phillips & Michael B. Avon, *The Supreme Court's Decision in O'Hagan: A Choice of Judicial Pragmatism over Ideology*, in SECURITIES ENFORCEMENT INSTITUTE, A PRACTICAL GUIDE TO INVESTIGATION, SETTLEMENT & LITIGATION 239, 239-60 (PLI Corp. Law & Practice Course Handbook Series No. B4-7240, 1997) (discussing the background of the *O'Hagan* decision, as

icant questions nonetheless remain unanswered, if not unaddressed. This Note focuses on the most significant unresolved question surrounding Rule 14e-3 in the wake of the *O'Hagan* decision: What is the rule's legitimate scope? This Note's analysis of the legitimate scope of Rule 14e-3 arises not out of anything the Court settled in *O'Hagan*, but rather from something specifically left unresolved by the Court—the applicability of Rule 14e-3 to the practice of “warehousing.”¹⁰

Before analyzing the practice of warehousing, this Note reviews Rule 14e-3 and the legal context of the *O'Hagan* controversy. The first section also discusses the legislative history of Rule 14e-3, as well as the legal treatment of the rule. Specifically, this exercise involves an effort to discern the legitimate scope of Rule 14e-3, in light of the Court's classification of Rule 14e-3 as a prophylactic rule. In addition, the first section discusses the Court's limiting language in *O'Hagan*, particularly in relation to the misappropriation theory and its potential application to Rule 14e-3. To facilitate a more lucid understanding of the implications of the *O'Hagan* decision, this discussion also provides a brief overview of the factual setting of the case. The first section concludes with an examination of the *O'Hagan* Court's formulation of the term “misappropriation” as presented in its analysis of Rule 10b-5.

The second section of this Note moves to a detailed examination of the practice of warehousing, including an explanation of the value of testing the boundaries of Rule 14e-3 with the specific practice of warehousing. The second section delineates the relationship of warehousing to insider trading generally, and the trading activity in *O'Hagan* specifically, through the use of a warehousing model that this Note constructs and employs in several scenarios. This model serves to highlight the significant distinctions between the activity described by the Court in *O'Hagan* and the practice of warehousing. With these distinctions revealed, this Note conducts a more detailed comparison

well as the implications of the Court's acceptance of Rule 14e-3).

10. See *O'Hagan*, 521 U.S. at 672 n.17 (“We leave for another day . . . the legitimacy of Rule 14e-3(a) as applied to ‘warehousing’ . . .”). For a basic explanation of the practice of warehousing, see *infra* notes 46-57 and accompanying text.

between misappropriation and warehousing, focusing upon the nature and the extent of both deception and nondisclosure within the two tender offer trading activities.

The third section directly addresses the issue of the legitimate scope of Rule 14e-3. By reexamining section 14(e) of the Securities Exchange Act of 1934, with a focus upon its authorization mandate, and the twin concerns of fairness and market integrity, this Note shows that the policy rationale undergirding section 14(e) does not carry over to the nature and extent of deception and nondisclosure exhibited within the practice of warehousing, and thus the legitimate prophylactic scope of Rule 14e-3 should not be expanded to warehousing.

Finally, the fourth section of this Note assesses the proper role of both the judiciary and Congress within the debate over insider trading regulation. This Note concludes that an expansion of the current framework of insider trading prohibition is an act best reserved for the legislature, where the significant public policy arguments may be debated and analyzed in a manner more consistent with the separation of powers doctrine.

SEC RULE 14e-3

Background and History

The SEC implemented Rule 14e-3 under the authority of section 14(e) of the Securities Exchange Act of 1934 ("Exchange Act"),¹¹ as a response to the perceived growth of problems of

11. Section 14(e) originally was enacted in 1968, as part of the Williams Act, Pub. L. No. 90-439, 82 Stat. 454, 457 (1968) (codified as amended at 15 U.S.C. § 78n(e)), with the intention of providing protection to shareholders involved in a tender offer. See Roger J. Dennis, *This Little Piggy Went to Market: The Regulation of Risk Arbitrage after Boesky*, 52 ALB. L. REV. 841, 874 (1988); William J. Cook, Note, *From Insider Trading to Unfair Trading: Chestman II and Rule 14e-3*, 22 STETSON L. REV. 171, 194-98 (1992); Roberta S. Karmel, *Authority for the Tender Offer Rules*, ANDREWS SEC. & COMMODITIES LITIG. REP., Feb. 12, 1997, at 3. In 1970, Congress added section 14(e)'s grant of rulemaking authority to the SEC in response to "increasingly sophisticated and rapidly changing techniques used in corporate takeovers and tender offers." Cook, *supra*, at 196. The rulemaking addition to section 14(e) reads: "The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative." 15 U.S.C. § 78n(e).

securities fraud within the specific realm of the tender offer.¹² Prior to the Supreme Court's decision in *O'Hagan*, the Eighth Circuit discredited Rule 14e-3, arguing that the SEC had exceeded

12. Applicable only in the specific context of a tender offer, the rule reads, in part:

[I]t shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

- (1) The offering person,
- (2) The issuer of the securities sought or to be sought by such tender offer, or
- (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell . . . any of such securities . . . unless within a reasonable time prior to any purchase or sale such information and its sources are publicly disclosed by press release or otherwise.

17 C.F.R. § 240.14e-3(a) (1998).

For a brief recitation of the legislative history of section 14(e), with an eye toward its compatibility with Rule 14e-3, see Laura Ryan, Comment, *Rule 14e-3's Disclose-or-Abstain Rule and Its Validity Under Section 14(e)*, 60 U. CIN. L. REV. 449, 453-65 (1991). Significantly, the SEC adopted Rule 14e-3 in 1980 based upon the Commission's belief that Congress intended section 14(e) to encompass a realm of tender offer trading activity "well beyond a bidder's duty of disclosure to target shareholders." Michael T. Raymond, *Validity Challenges to SEC Rule 14e-3*, 23 J. MARSHALL L. REV. 305, 309-10 (1990). The SEC's interpretation is debatable in light of the "noticeabl[e] absen[ce]" of an expressed congressional intent within the legislative history of section 14(e) "to impose duties upon persons *other* than bidders and those opposing a tender offer." *Id.* at 309 (emphasis added); see Samuel N. Allen, Note, *The Scope of Disclosure Duty under SEC Rule 14e-3*, 38 WASH. & LEE L. REV. 1055, 1062-63 (1981); Cook, *supra* note 11, at 194-98; see also Michael J. Voves, Comment, *United States v. O'Hagan: Improperly Incorporating Common Law Fiduciary Obligations into § 14(e) of the Securities Exchange Act*, 81 MINN. L. REV. 1015, 1035 (1997) ("Congress narrowly tailored the Williams Act's provisions to regulate disclosure of information between persons making tender offers and target companies."); Karmel, *supra* note 11, at 3 ("[T]he purpose of the [Williams Act] was to protect investors when confronted with an offer to purchase their shares . . . through disclosure . . .").

For an analysis and evaluation of the validity and wisdom of Rule 14e-3, see generally Samuel H. Gruenbaum, *The New Disclose or Abstain From Trading Rule: Has the SEC Gone Too Far?*, 4 CORP. L. REV. 350 (1981) (concluding that Rule 14e-3 deserves close scrutiny from the courts), and Mary F. Hill, Note, *Trading on Material, Nonpublic Information Under Rule 14e-3*, 49 GEO. WASH. L. REV. 539 (1981) (proposing the need for a separate analysis of sections 10(b) and 14(e) in the wake of the adoption of Rule 14e-3 and *Chiarella v. United States*, 445 U.S. 222 (1980)).

its permissible rulemaking authority as framed by section 14(e) of the Exchange Act.¹³ The Eighth Circuit focused its analysis on the scope of authority intended by Congress in its grant of power to the SEC—within section 14(e)—to “define, and prescribe means reasonably designed to prevent” fraudulent acts in connection with a tender offer.¹⁴ In particular, the court questioned the legitimacy of Rule 14e-3 in light of the absence of any requirement that a prohibited “fraudulent” act involve an actual breach of fiduciary duty.¹⁵ On the basis of this very argument, the Eighth Circuit reversed the criminal convictions against James O’Hagan.¹⁶ The Supreme Court, however, did not agree with the Eighth Circuit,¹⁷ and ruled that the SEC had not exceeded its rulemaking authority in adopting Rule 14e-3 or in

13. See *United States v. O’Hagan*, 92 F.3d 612, 622-27 (8th Cir. 1996), *rev’d*, 521 U.S. 642 (1997). Other decisions assessing the validity of Rule 14e-3 differ markedly. See generally Ryan, *supra* note 12, at 474-81 (examining a variety of caselaw assessing the validity of Rule 14e-3).

14. 15 U.S.C. § 78n(e). As such, this Note focuses primarily on the legal aspects of the SEC’s rulemaking authority. The related topic of SEC rulemaking and regulation as applied to public policy theory, although not essential to an understanding of the legal arguments presented herein, involves many similar issues and raises significant questions in the field of securities regulation and enforcement. See generally Donald C. Langevoort, *The SEC as a Bureaucracy: Public Choice, Institutional Rhetoric, and the Process of Policy Formation*, 47 WASH. & LEE L. REV. 527 (1990) (concluding that an understanding of policy formation within any administrative agency is important because one can determine the proper amount of deference to give to the agency’s statutory interpretation, and questioning conventions may create a positive impetus for change within the agency); William R. McLucas et al., *Common Sense, Flexibility, and Enforcement of the Federal Securities Laws*, 51 BUS. LAW. 1221 (1996) (reviewing the SEC’s enforcement actions and providing criteria to judge the SEC’s effectiveness).

15. See *O’Hagan*, 92 F.3d at 622-27. O’Hagan argued that the grant of authority under section 14(e) limits the SEC to creating rules that prohibit only those activities that are in and of themselves *fraudulent*. See *id.* at 623-24. Under traditional insider trading law, only those persons “inside” the corporation, such as corporate officers and directors, could be subject to fraud through insider trading. See generally *Using High Court Guidelines, Eighth Circuit Reverses Insider Ruling*, ANDREWS DERIVATIVES LITIG. REP., May 7, 1998, at 11-12 [hereinafter *Using High Court Guidelines*] (discussing the Eighth Circuit’s treatment of *O’Hagan* on remand).

16. See *O’Hagan*, 92 F.3d at 627; see also Swanson, *supra* note 3, at 1182-91 (discussing the Eighth Circuit’s analysis and decision in *O’Hagan*).

17. See *United States v. O’Hagan*, 521 U.S. 642, 676 (1997). Although the Court overruled the Eighth Circuit’s decision as it pertained to the validity of Rule 14e-3, one commentator described the Court’s ultimate assessment of Rule 14e-3 as a “somewhat grudging affirmance.” McLaughlin, *supra* note 6, at 1.

applying the rule to the type of activity that was presented in *O'Hagan*,¹⁸ thus seemingly placing to rest the legal battle over the legitimacy of Rule 14e-3.¹⁹

The remainder of this Note argues otherwise, showing that the limits to Rule 14e-3's legitimate scope are still very much in question. By employing the practice of warehousing as a foundation for the construction of a basic model to illustrate the possibility that trading on the basis of nonpublic information in the context of a tender offer, and in the absence of a breach of fiduciary duty, in fact legitimately may fall outside of the permissible scope of post-*O'Hagan* Rule 14e-3, this Note attempts to clarify the boundaries of Rule 14e-3.

Scope of Rule 14e-3 Post O'Hagan

In the opening paragraph of the *O'Hagan* decision, Justice Ginsburg, writing the opinion of the Court,²⁰ framed one of the two "prime questions" posed by the *O'Hagan* appeal: "Did the [SEC] exceed its rulemaking authority by adopting Rule 14e-3(a), which proscribes trading on undisclosed information in the tender offer setting, even in the absence of a duty to disclose?"²¹

18. See *O'Hagan*, 521 U.S. at 666-77, 692-700 (Thomas, J., concurring in the judgment in part and dissenting in part). See generally Phillips & Avon, *supra* note 9, at 257-59 (describing the Court's acceptance of Rule 14e-3 in *O'Hagan*).

19. The Court's decision has spared the government the need, "in marginal cases, to conduct the mental contortions necessary to 'uncover' a duty that has been breached." Pitt et al., *supra* note 3, at 75. In the process of formulating the *O'Hagan* decision, however, some have argued that the Court ignored the fundamental principles of administrative law. See E. Livingston B. Haskell, Note, "Disclose-or-Abstain" Without Restraint: The Supreme Court Misses the Mark on Rule 14e-3 in *United States v. O'Hagan*, 55 WASH. & LEE L. REV. 199, 225-30 (1998) (asserting that the Supreme Court ignored a fundamental rule of administrative law by evaluating the validity of Rule 14e-3 on a basis other than the one that the SEC provided at the time of the original rulemaking action).

20. Three Justices disagreed with the majority opinion. Justices Scalia and Thomas dissented from Court's opinion concerning Rule 10b-5. See *O'Hagan*, 521 U.S. at 679 (Scalia, J., concurring in part and dissenting in part), 680 (Thomas, J., concurring in the judgment in part and dissenting in part). The Chief Justice and Justice Thomas rejected the Court's Rule 14e-3 opinion. See *id.* at 680 (Thomas, J., concurring in the judgment in part and dissenting in part).

21. *Id.* at 647. The Court framed the other "prime question"—outside the scope of this Note—as follows: "Is a person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source

In the process of addressing this question, the Court first signaled a potential willingness to limit the breadth of its Rule 14e-3 holding in *O'Hagan*: "Our answer to . . . [this] question, . . . viewed in the context of this case, [is] no."²²

To understand the potential significance of this limitation, it is first essential to understand the context in which the *O'Hagan* Court held that Rule 14e-3 properly applied.²³ James O'Hagan was a lawyer with a firm retained as counsel by a large corporation in anticipation of a potential takeover by means of a tender offer.²⁴ Although not involved personally in this representation, O'Hagan learned of the client's plans to initiate a takeover bid for another corporation, and proceeded to use this knowledge to acquire both common stock and call options of the potential target corporation.²⁵ Within this specific context, the Court focused its analysis and final determination on the fact that the corporation from which *O'Hagan* had indirectly acquired information regarding the potential tender offer had no knowledge of,²⁶ and had not consented to,²⁷ O'Hagan's

of the information, guilty of violating § 10(b) and Rule 10b-5?" *Id.*

22. *Id.* (emphasis added). Addressing this issue later in the opinion, the Court reiterated this potential limitation, stating that "[w]e hold that the [SEC], in this regard and to the extent relevant to this case, did not exceed its authority." *Id.* at 667 (emphases added). The practical effect of the Court's limiting language, which was unnecessary in reaching the specific determination settled in *O'Hagan*, is to create, at a minimum, some degree of latitude for the Court's future assessments of the legitimacy of Rule 14e-3. Even further, the *O'Hagan* decision indicates a cognizable level of weariness concerning the legitimacy of Rule 14e-3 as applied to situations distinct from *O'Hagan*. See generally Swanson, *supra* note 3, at 1210 (stating that the Court's "lukewarm endorsement of Rule 14e-3(a) transforms a relatively clear and efficient enforcement tool into another question mark to be resolved in a different case").

23. For a more in-depth examination of the facts of *O'Hagan*, see Bencivenga, *supra* note 3, at 5; Prozan, *supra* note 3, at 58; *High Court Insider Trading Decision May Leave Question*, *supra* note 6.

24. See *O'Hagan*, 521 U.S. at 647. Grand Metropolitan PLC ("Grand Met") was the bidding corporation. For another insider trading case arising out of Grand Met's bid, see *SEC v. Falbo*, 14 F. Supp. 2d 508, 513 (S.D.N.Y. 1998).

25. See *O'Hagan*, 521 U.S. at 647. The Pillsbury Corporation was the target corporation. Directly from his series of Pillsbury trades, James O'Hagan took away over \$4.3 million worth of "dough." See *id.* at 648.

26. See *id.* at 667-77 (focusing on the problematic nature of securities trading based upon nonpublic information in situations in which the source of the information is unaware that such information has become public or "leaked").

27. See *id.* (discussing the role of obtaining the consent of one's source within the

trading.²⁸ O'Hagan's failure to notify the corporate source of his trading plans was especially significant in this context. Although O'Hagan's lack of any personal association with the target corporation put into question the formation of a fiduciary duty traditionally required as an element of fraud within the realm of insider trading,²⁹ the Court's classification of Rule 14e-3 as a "prophylactic measure"³⁰ had the effect of generating an area, *outside* that of traditional or common-law fraud, in which Rule 14e-3 nonetheless may operate permissibly.³¹ As such, by applying Rule 14e-3 to the specific facts of the *O'Hagan* case, the Court stated that "insofar as it serves to prevent the type of *misappropriation* charged against O'Hagan, Rule 14e-3(a) is a proper exercise of the [SEC's] prophylactic power under [section] 14(e)."³²

From this statement, it is clear that although the Court recognized that misappropriation of nonpublic information may fall

context of inside information-based trading); see also Coffee, *supra* note 4, at 6 (referring to the "consent to use" analysis in *O'Hagan* as the "linchpin of [the majority opinion's] theory of deception").

28. As evidenced in *O'Hagan*, the misappropriation of inside information frequently involves both Rule 10b-5 and Rule 14e-3. Nearly half of the SEC's "misappropriation" cases are set within the context of a tender offer, thus implicating both rules. See Smith, *supra* note 3, at 75 (noting that almost half of the SEC's misappropriation cases also address the tender offer rule).

29. See *supra* notes 15-16 and accompanying text.

30. See *O'Hagan*, 521 U.S. at 672-73 ("A prophylactic measure, because its mission is to prevent, typically encompasses *more* than the core activity prohibited." (emphasis added)). Courts also have justified the extension of Rule 14e-3 to nonfraudulent activity based on the difficulties associated with proving actual fraud within the context of tender offer trading activity. See, e.g., *id.* at 673-74; SEC v. Maio, 51 F.3d 623, 635 (7th Cir. 1995); SEC v. Peters, 978 F.2d 1162, 1167 (10th Cir. 1992); United States v. Chestman, 947 F.2d 551, 559 (2d Cir. 1991); see also Voves, *supra* note 12, at 1030-31 (noting cases interpreting the validity of Rule 14e-3).

31. The *O'Hagan* Court addressed the "latitude" surrounding the legitimate scope of Rule 14e-3, holding that "under [section] 14(e), the [SEC] may prohibit acts, not themselves fraudulent under the common law . . . if the prohibition is 'reasonably designed to prevent . . . acts and practices [that] are fraudulent.'" *O'Hagan*, 521 U.S. at 673.

32. *O'Hagan*, 521 U.S. at 676 (emphasis added). Several commentators have noted that the "extreme" and "egregious" facts of the *O'Hagan* case, such as O'Hagan's previous embezzlement from client trust funds, may well have driven the Court's decision to allow the use of the misappropriation theory in this case. But see, e.g., Pitt et al., *supra* note 3, at 72 (noting that *O'Hagan* has implications beyond the narrow facts of the case).

outside the area of traditional fraudulent fiduciary breach, it also acknowledged that misappropriation nonetheless may fall *within* the prophylactic, and thus legitimate, scope of Rule 14e-3.³³ By focusing its analysis and decision regarding the prophylactic scope of Rule 14e-3 on the specific facts implicated in *O'Hagan*, the Court apparently limited, at least for the present time, its holding as to the validity of applying Rule 14e-3 to situations involving either traditional breach of fiduciary duty and fraud or a "misappropriation" of inside information regarding a tender offer.³⁴

Rule 14e-3 and Misappropriation

The Court's use of the term "misappropriation" in describing the context in which Rule 14e-3 may be applied legitimately cannot, within the *O'Hagan* decision, be considered a vague or shifting term of art. In its discussion of James O'Hagan's Rule 10b-5 violations,³⁵ the Court analyzed, and ultimately approved, the "misappropriation theory" of insider trading liability.³⁶ In the

33. The Court's specific use of the term "misappropriation" in this instance, *see O'Hagan*, 521 U.S. at 676, hardly can be considered insignificant within the Rule 14e-3 discussion, in light of the extensive analysis of that very term within the Court's Rule 10b-5 analysis. *See id.* at 650-66; *see also infra* notes 35-41 and accompanying text (discussing use of the term "misappropriation" within the *O'Hagan* opinion's Rule 10b-5 and Rule 14e-3 analysis).

34. The Court's limitation contrasts sharply with the SEC's position regarding the legitimacy of Rule 14e-3 as applied to warehousing, as well as to other nonfraudulent tender offer activity based on nonpublic information: "The prohibitions of Rule 14e-3 apply even if the person charged with a violation does not owe a fiduciary or other duty to the issuer or its shareholders and *even if no prohibition against misappropriation has been violated.*" RALPH C. FERRARA ET AL., FERRARA ON INSIDER TRADING AND THE WALL § 2.04[1], at 2-40.7 n.4 (1998) (emphasis added) (quoting SEC Chairman David Ruder, Remarks Before the National Investor Relations Institute 7 (Nov. 11, 1987)).

35. Rule 10b-5 operates as a general antifraud provision within the securities law framework. *See* John F. Olson et al., *Report of the Task Force on Regulation of Insider Trading, Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934*, 41 BUS. LAW. 223, 230 (1985). In comparison to Rule 14e-3, Rule 10b-5 is more general in that it applies to the purchase or sale of any security, as opposed to Rule 14e-3's specific and exclusive applicability to the tender offer setting. *See generally* THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 13.2, at 760-69 (3d ed. 1996) (presenting a brief overview of Rule 10b-5).

36. *See O'Hagan*, 521 U.S. at 650-53 (1997) ("In lieu of premising liability on a

process of doing so, the Court articulated specific elements that, when pieced together, provide a definition of "misappropriation" within the context of securities regulation.³⁷

First, the Court required *deception*.³⁸ Further, the Court appeared to link the concept of deception within misappropriation to *nondisclosure*.³⁹ According to the *O'Hagan* Court, deceptive nondisclosure, in this context, "constitutes fraud akin to embezzlement" in which "[a] fiduciary . . . [pretends] loyalty to the principal while secretly converting the principal's information for personal gain."⁴⁰ Finally, and perhaps most significantly, the Court rather narrowly limited liability under the misappropriation theory to nondisclosure by the trader to the *source* of the nonpublic information.⁴¹ Pieced together, then, the ensuing *O'Hagan* definition of misappropriation involves (1) deception; (2) through nondisclosure; (3) to the source of the acquired nonpublic information.

fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."); see also *id.* at 650-66 (analyzing the development of the misappropriation theory and applying it to the facts of the *O'Hagan* case).

37. See *id.* at 650-66. One must keep in mind, of course, that *O'Hagan's* analysis of the necessary elements of a legitimately-prohibited act of misappropriation pertains specifically to Rule 10b-5. As a result, this analysis does *not* necessarily carry over to Rule 14e-3, particularly in light of the deliberate degree of breadth provided in Rule 14e-3—a breadth not found in Rule 10b-5.

This Note in fact argues that the use of the specific term "misappropriation" within the Court's Rule 14e-3 assessment of James O'Hagan's activities strongly suggests that a similar analysis will hold under *both* rules. That these elements apply with equal force to both Rule 10b-5 and Rule 14e-3 is "the most logical explanation for why the Court indicated in a footnote that Rule 14e-3 might not apply to warehousing transactions." Coffee, *supra* note 4, at 17; see also Voves, *supra* note 12, at 1045-46 (discussing the notion of a "misappropriation theory" of Rule 14e-3 liability).

38. See *O'Hagan*, 521 U.S. at 653 ("We observe, first, that misappropriators . . . deal in *deception*." (emphasis added)).

39. See *id.* at 654 ("Deception through *nondisclosure* is central to th[is] theory of liability . . ." (emphasis added)). According to the Court, the converse of this proposition is also true, as "full disclosure forecloses liability under the misappropriation theory." *Id.* at 655.

40. *Id.* at 653 (quoting Brief for United States at 17, *O'Hagan* (No. 96-042)).

41. See *id.* at 655 n.6 ("[T]he disclosure obligation runs to the *source* of the information . . ." (emphasis added)). But see *Chiarella v. United States*, 445 U.S. 222, 240 (1980) (Burger, C.J., dissenting) (discussing an "absolute duty" of disclosure).

Placing this formulation in the context of Rule 14e-3 and the tender offer scenario, it is apparent why the Eighth Circuit, on remand, determined James O'Hagan's trading activity to be properly within this definition of misappropriation, and thus within the scope of Rule 14e-3's prophylactic reach.⁴² Similarly, it is now evident that this type of misappropriation is subject to Rule 14e-3 liability. With this much established by *O'Hagan*, the pertinent question becomes whether the *O'Hagan*-type of misappropriation⁴³ constitutes the outer limit of the legitimate scope of Rule 14e-3, or whether Rule 14e-3's prophylactic nature allows it to be extended legitimately to encompass tender offer trading activity that, while based on nonpublic information, does not fit cleanly into either the *O'Hagan* definition of misappropriation,⁴⁴ or the *O'Hagan*-type misappropriation context.⁴⁵

WAREHOUSING

Background

The practice of warehousing essentially involves "issuer-motivated tipping [of inside information regarding a future tender offer for control of a corporate target] in advance of the offer to place target stock in friendly hands before the offer commences."⁴⁶ The practice of warehousing is ripe for post-*O'Hagan* Rule 14e-3 analysis for at least two distinct reasons. First, warehousing activity involves securities trading based on nonpublic information within the tender offer context, yet it entails significant distinctions as compared to the *O'Hagan*-type misappropriation tender offer activity.⁴⁷ Second, the legitimacy of Rule 14e-3, as

42. See *United States v. O'Hagan*, 139 F.3d 641, 647-49 (8th Cir. 1998), on remand from 521 U.S. 642 (1997); see also *Using High Court Guidelines*, *supra* note 15, at 11-12 (analyzing the court's decision on remand).

43. This Note uses the phrase, "*O'Hagan*-type misappropriation" to describe the specific factual situation in which James O'Hagan both acquired and used nonpublic information regarding a tender offer.

44. See *supra* notes 35-41 and accompanying text (discussing the *O'Hagan* Court's formulation of the term "misappropriation").

45. The remainder of this Note also assumes that the activity being analyzed does not involve clear-cut insider trading based on traditional or common-law fraud.

46. Dennis, *supra* note 11, at 879 n.204.

47. See *infra* notes 58-73 and accompanying text.

applied to the practice of warehousing, is an issue explicitly left open and unresolved by the Court in *O'Hagan*.⁴⁸ This suggests that, at least potentially, the distinctions involved in the practice of warehousing—vis-a-vis *O'Hagan*-type misappropriation—may leave warehousing outside of the legitimate prophylactic scope of Rule 14e-3.⁴⁹ If this is the case, delineating the distinctions that may place warehousing outside of Rule 14e-3's legitimate reach will provide valuable insight toward a more lucid understanding of the proper prophylactic scope of Rule 14e-3.

Warehousing activity, as defined in *O'Hagan*, involves "the practice by which bidders leak advance information of a tender offer to allies and encourage them to purchase the target company's stock before the bid is [publicly] announced."⁵⁰ For one or more of several potential reasons, plans to initiate a tender offer may be divulged deliberately by the bidder—sometimes to friends or family, but more often to business allies—well before an actual tender offer has been publicly announced and launched.⁵¹ The practical effect of leaking inside information about a tender offer is to allow the recipient of the information

48. See *supra* note 10 and accompanying text.

49. Interestingly, although the Court in *O'Hagan* left unresolved the issue of Rule 14e-3's legitimacy as applied to warehousing, the Court in *Chiarella v. United States*, 445 U.S. 222 (1980), made specific reference to the SEC's intent in promulgating Rule 14e-3 to bar the practice of warehousing. See *id.* 234.

50. *United States v. O'Hagan*, 521 U.S. 642, 672 n.17 (1997) (quoting Government Reply Brief at 17, *O'Hagan* (No. 96-842)).

51. Although deliberate dissemination of nonpublic information regarding plans to initiate a tender offer often occurs for personal reasons, more often—and more significantly in terms of impact upon the market—business purposes provide the ultimate motivation. For example, a corporation planning a tender offer may tip large institutional investors, such as the managers of mutual or pension funds, with the expectation that these managers will purchase large blocks of the target stock at market price, and then quickly tender the shares to the bidder once the tender offer has been announced publicly. See generally William J. Carney, *Signalling and Causation in Insider Trading*, 36 CATH. U. L. REV. 863, 893 (1987) (describing the general procedure followed in a tipping situation); Helen A. Garten, *Insider Trading in the Corporate Interest*, 1987 WIS. L. REV. 573, 606-07, 630 (discussing the "good will" explanation of a corporate insider's motivation for tipping of information to certain investors although receiving no apparent tangible personal or corporate benefit); Cook, *supra* note 11, at 184 n.84 (defining warehousing as a means by which investors can purchase stock in a target company before stock prices rise); Voves, *supra* note 12, at 1043-45 (discussing the insider's rationale for tipping).

to purchase securities of the target company at a market price below—often substantially below—the value of the very same securities upon public initiation of the tender offer.⁵²

A simplified example may help to illustrate the practice of warehousing. Corporation *B*, the bidder, is planning to initiate a tender offer for the common stock, and thus control, of Corporation *T*, the target.⁵³ The common stock of Corporation *T* is trading on the market at ten dollars per share. Corporation *B* has determined that it will initiate a tender offer, for all outstanding shares of common stock of Corporation *T*, at a price of twenty dollars per share; additionally, Corporation *B* internally has determined that, if necessary, it will be willing to increase this offer up to thirty dollars per share.

Before Corporation *B* has disclosed its plans regarding the impending tender offer to anyone outside of the company's directors and officers, it summons person *P* to its corporate offices. *P* manages a large mutual fund. After disclosing its plans to initiate a tender offer for Corporation *T*, Corporation *B* makes absolutely clear to *P* that it does not, and will not, in any way object to *P* using this nonpublic information, of which it alone is the source, as a basis for acquiring securities of Corporation *T* on the open market.⁵⁴ At this time, no one associated with Corporation *T*, including its shareholders, is aware of Corporation *B*'s plans. Immediately upon receiving the information from Corporation *B*, *P* purchases common stock of Corporation *T* at the prevailing market price of ten dollars per share. Acquired through a

52. The share offering price is set above the market price by the bidder to account for the value of control over the target company the bidder seeks to acquire. See Voves, *supra* note 12, at 1015, n.3; see also HAMILTON, *supra* note 7, at 1139 (defining share offering price).

53. Obviously, the driving force behind initiation of a tender offer is a perceived opportunity to make money. See Richard A. Booth, *The Efficient Market, Portfolio Theory, and the Downward Sloping Demand Hypothesis*, 68 N.Y.U. L. REV. 1187, 1191 n.6 (1993) ("A bidder would not make a bid for a target company unless it was expected to be profitable."). Theoretically, profitability will result from establishing a tender offer bid price for an amount somewhat less than what the bidder expects to realize upon obtaining control of the target corporation by either instituting operational changes or selling off assets. See *id.*

54. In fact, the more likely scenario involves Corporation *B* actively encouraging *P* to purchase shares of Corporation *T*. See *supra* note 51 and accompanying text.

broker on the open market, *P* has no feasible way to know, or learn, the identity of any of the sellers from which the Corporation *T* common stock has been acquired.

Three weeks later, Corporation *B* makes public its initiation of a tender offer for the stock of Corporation *T* at a price of twenty dollars per share.⁵⁵ In response to this public announcement, the market price for shares of Corporation *T* rises.⁵⁶ Several weeks after the announcement, Corporation *B* completes the tender offer by accepting the submitted shares of Corporation *T* common stock and tendering twenty dollars per share to all who submitted stock. *P* is among those who tender stock to Corporation *B*; the mutual fund that *P* manages profits by ten dollars per share of Corporation *T* common stock. Throughout this entire process, Corporation *B* has received no direct pecuniary benefit as a result of its "tipping" of its own nonpublic information to *P*.⁵⁷

Although oversimplified, this basic scenario serves as an adequate foundation for the following examination of the legitimacy of Rule 14e-3 as applied to the practice of warehousing.

Warehousing and Misappropriation

The *O'Hagan* case teaches that securities trading in the context of a tender offer, which properly may be characterized as involving misappropriation of nonpublic information, even without an element of common-law fraud, will nonetheless fall within

55. Once a corporation announces a tender offer, rather than accepting shares directly, a bidder appoints a "depository" that accepts and accounts for the tendered shares on behalf of the bidder. See James R. Pagano, Note, *The Constitutionality of Second Generation Takeover Statutes*, 73 VA. L. REV. 203, 203 n.1 (1987) (discussing the mechanics of tender offers).

56. The market price typically will approach the established tender offer value—in this case, \$20. Any market discrepancy in value represents the risk, as perceived by the market, that the tender offer will fail. For a more detailed and technical analysis of the dynamics of the relationship between the market price and the tender offer price of a security, focusing particularly on the role of risk arbitrage, see Dennis, *supra* note 11, at 846-50.

57. This is not to suggest, however, that all meaningful benefit necessarily must be pecuniary in nature. See *Dirks v. SEC*, 463 U.S. 646, 663-64 (1983) (noting that the benefit requirement also includes tips offered as a gift); Voves, *supra* note 12, at 1028 n.28.

the legitimate prophylactic scope of Rule 14e-3.⁵⁸ If, by examining the warehousing practice, a sufficiently correlative relationship can be established between warehousing activity and the activity that occurred in *O'Hagan*,⁵⁹ it follows that proscription of warehousing must be deemed a legitimate function of Rule 14e-3.⁶⁰ That such a correlative relationship does not in fact exist becomes evident through a comparison between the *O'Hagan*-type misappropriation trading activity and the warehousing scenario delineated above.

Recall the elements of securities trading misappropriation highlighted by the Court in *O'Hagan*: deception through nondisclosure to the source of the nonpublic information.⁶¹ With these elements in mind, reconsider the warehousing scenario developed above.⁶² The nature of the deception involved in the warehousing scenario, if any exists at all,⁶³ clearly is distinct from the nature of the deception addressed by the Court in *O'Hagan*.⁶⁴ In the warehousing scenario, *P*'s role in the acquisition of the nonpublic information was entirely passive,⁶⁵ and *P*'s use of the information as the basis for trading was not only known to the source of the inside information, but was in fact encouraged by the bidding corporation.⁶⁶

58. See *United States v. O'Hagan* 521 U.S. 642, 676-77 (1997). This notion has been applied recently in *SEC v. Mayhew*, 121 F.3d 44, 50-53 (2d Cir. 1997).

59. See Voves, *supra* note 12, at 1045-47 (discussing "misappropriation theory" under section 14(e)).

60. To a certain extent, of course, this begs the question of exactly what constitutes a "sufficient" correlative relationship, an issue that a subsequent section of this Note addresses.

61. See *supra* notes 38-41 and accompanying text.

62. See *supra* notes 53-57 and accompanying text.

63. The nature of deception within the practice of warehousing will be more thoroughly examined below. See *infra* notes 88-124 and accompanying text. For present purposes, it suffices simply to note that the nature and extent of the deception involved in both the acquisition and the use of the nonpublic information in the *O'Hagan*-type misappropriation situation is markedly distinct from the nature and extent of the acquisition and use of nonpublic information in the warehousing scenario.

64. See *United States v. O'Hagan*, 521 U.S. 642, 653-54 (1997); see also *supra* notes 38-41 and accompanying text (discussing the meaning of "deception").

65. Some commentators view the manner in which the inside information is acquired, or the "means of discovery," as one method by which to distinguish fraudulent from nonfraudulent insider trading. See, e.g., Dalley, *supra* note 2, at 1329.

66. At least in regard to the trader and the principal, (or source of the nonpublic

Similarly, the nature and extent of nondisclosure in the two situations differ significantly.⁶⁷ This dissimilarity is linked directly to the distinct role played by the source of the nonpublic information in each situation. In the *O'Hagan* misappropriation case, not only was the public disclosure required by Rule 14e-3 absent, but additionally, and more significantly, no disclosure to the source of the information occurred.⁶⁸ Interestingly, it was this latter type of nondisclosure that the Court focused on when justifying Rule 14e-3's legitimate application to O'Hagan's activity.⁶⁹ This makes perfect sense, as nondisclosure to the source of the nonpublic information was a central element leading to the *O'Hagan* Court's conclusion that the securities trading involved misappropriation, which in turn placed James O'Hagan's trading activity within the legitimate prophylactic scope of Rule 14e-3.⁷⁰

information) then, no deception has occurred.

67. Of course, as presently written, Rule 14e-3 requires disclosure to the *public* in *all* situations involving nonpublic information concerning a tender offer, *regardless* of the source, or the source's willingness to divulge such information. See 17 C.F.R. § 240.14e-3(a) (1998). Using this fact as a basis to avoid making the comparison between the nature and extent of nondisclosure in *O'Hagan* versus that exhibited in the warehousing practice, however, first requires making the assumption that Rule 14e-3, as written, is entirely, and in all cases, legitimately within the authorized scope of section 14(e) of the Exchange Act. It is the validity of this very assumption, however, that this Note scrutinizes. Rather than being a moot exercise, the comparison of nondisclosure therefore becomes extremely meaningful.

68. This type of nondisclosure—nondisclosure to the source of the nonpublic information—is the heart of the misappropriation that the Court in *O'Hagan* ruled to be within the prophylactic reach of Rule 14e-3. See *O'Hagan*, 521 U.S. at 675-76; see also *supra* note 41 and accompanying text (discussing the Court's treatment of the "source" of nonpublic information). But see *infra* note 70 (noting that in *O'Hagan*, the Court's focus on nondisclosure to the source did not preclude it from finding that Rule 14e-3's general public disclosure requirement is valid).

69. See *O'Hagan*, 521 U.S. at 654-55 (focusing on the role of deception within nondisclosure to the source of the nonpublic information).

70. It is worth mentioning again that the Court's focus on the nondisclosure to the source of the nonpublic information in *O'Hagan* in no way precluded it from determining that Rule 14e-3's more general public disclosure requirement was in fact valid. See *supra* note 37 and accompanying text (discussing the relation between the Court's Rule 10b-5 and Rule 14e-3 misappropriation analyses). The Court's opinion in *O'Hagan* did not address the validity of public disclosure because it had no need to do so; by focusing on James O'Hagan's misappropriation of nonpublic information from the information's source, the Court avoided any in-depth analysis beyond the specific facts at hand. See *O'Hagan*, 521 U.S. at 673 n.17 ("The instant case . . . does not involve trading authorized by a principal; therefore, we need not here decide

In contrast, the only nondisclosure occurring in *O'Hagan* that also appears in the warehousing scenario is *P*'s failure to make a *public* disclosure as required explicitly by the terms of Rule 14e-3.⁷¹

In the warehousing example, the notion of *P* making a disclosure to the *source*, Corporation *B*, is moot, as Corporation *B* leaked the nonpublic information to *P* for the specific purpose of encouraging and allowing *P* to initiate trading based on the information. Whether the lack of nondisclosure to the source of the inside information in the warehousing scenario is a fact sufficient to remove the activity from the legitimate scope of Rule 14e-3 is addressed below.⁷² For present purposes, in light of the Court's focus on nondisclosure to the *source* as an element of *O'Hagan*-type misappropriation, the lack of nondisclosure to the source within the warehousing scenario simply furthers the distinction between the two types of securities trading within the tender offer context. The possibility that the practice of warehousing may escape the legitimate prophylactic reach of Rule 14e-3 as shaped by the Court's decision in *O'Hagan* therefore remains open.⁷³

WAREHOUSING: OUTSIDE THE PROPHYLACTIC SCOPE OF RULE 14e-3?

The remainder of this Note, by focusing on the legitimacy of proscription of the practice of warehousing under Rule 14e-3, attempts to demarcate the limit of Rule 14e-3's valid prophylactic reach, in light of its authority under section 14(e) of the Exchange Act.

whether the [SEC]'s proscription of warehousing falls within its § 14(e) authority to define or prevent fraud.") (emphasis added).

71. See 17 C.F.R. § 240.14e-3(a).

72. See *infra* notes 74-124 and accompanying text.

73. The "possibility" raised here involves the analytical state of Rule 14e-3 as applied to warehousing; the legal state, of course, has been addressed previously. See *supra* notes 8-9 and accompanying text.

Exchange Act Section 14(e) Revisited

Section 14(e) of the Exchange Act,⁷⁴ which deals exclusively with the trading of securities within the tender offer context, authorizes the SEC as follows: "The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."⁷⁵ In evaluating the legitimacy of SEC rules issued pursuant to section 14(e)'s authorization, the Supreme Court consistently has focused on the phrase "means reasonably designed to prevent" fraud.⁷⁶ As noted previously,⁷⁷ the Court has interpreted this phrase to authorize SEC prohibition not only of the "core" activity, namely fraud,⁷⁸ but also of sufficiently related activity that, although not necessarily fraudulent, nonetheless falls within the prophylactic scope of a rule "reasonably designed" to prevent the core activity.⁷⁹

Applied specifically to Rule 14e-3, the Court's interpretation of section 14(e)'s authorization restricts the SEC to legitimate prohibition of tender offer trading activity that either (a) is itself fraudulent, or (b) is perceived to be so similarly related to fraud-

74. 15 U.S.C. § 78n(e) (1994).

75. *Id.* In its entirety, section 14(e) reads:

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

Id.

76. See, e.g., *United States v. O'Hagan*, 521 U.S. 642, 673 (1997); *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 11 n.11 (1985).

77. See *supra* notes 30-31 and accompanying text.

78. The Court has interpreted the section 14(e) terms "fraudulent," "deceptive," and "manipulative" as possessing the identical meaning. See *Schreiber*, 472 U.S. at 8; *Voves*, *supra* note 12, at 1019 n.21.

79. See *O'Hagan*, 521 U.S. at 673; see also *supra* note 75 and accompanying text (reciting mandate of section 14(e)).

ulent activity as to render its prohibition necessary to ensure compliance and allow for effective enforcement of the rule.⁸⁰ In effect, the *O'Hagan* Court's inclusion of "akin to fraud" situations within the legitimate scope of Rule 14e-3 acknowledges the practical necessity for some degree of a prophylactic safety-net as the means for enabling the SEC to achieve the ends Congress intended in its enactment of section 14(e).⁸¹

There must, however, be some limit to the legitimate reach of the prophylactic safety-net embodied in Rule 14e-3. Eventually, the Court will have to determine exactly what type of tender offer trading activity—beyond misappropriation—that although nonfraudulent, must nonetheless be proscribed so as to ensure that the prohibition of section 14(e) "core" activity may be enforced adequately. Having learned from *O'Hagan* that Rule 14e-3's prophylactic scope legitimately prohibits misappropriation of nonpublic information,⁸² a further determination of the rule's legitimate scope, in turn, revolves around an analysis of the practice of warehousing.

Legitimacy Considerations: Rule 14e-3's Extension to Warehousing

As illustrated previously, the practice of warehousing within the context of a tender offer is distinguishable in several ways from the misappropriation scenario in *O'Hagan*.⁸³ It seems clear from the warehousing model developed above⁸⁴ that warehousing involves neither the nature nor the extent of "deceptive nondisclosure to the source" targeted in *O'Hagan*.⁸⁵ This determination, although necessary, is, however, by no means sufficient to support the conclusion that the prohibition of warehousing is

80. See *O'Hagan*, 521 U.S. at 674-75; see also *supra* note 30 (discussing difficulties in enforcement).

81. See *O'Hagan*, 521 U.S. at 674-75.

82. See *supra* notes 15-19 and accompanying text.

83. See *supra* notes 61-73 and accompanying text (comparing the practice of warehousing in the context of a tender offer with *O'Hagan*-type misappropriation).

84. See *supra* notes 53-57 and accompanying text.

85. See *supra* notes 35-45 and accompanying text (discussing the *O'Hagan* Court's use of the term "misappropriation" in the context of Rule 14e-3); see also *O'Hagan*, 521 U.S. at 650-77 (discussing nondisclosure as defined by Rule 14e-3).

beyond the legitimate prophylactic scope of Rule 14e-3 as authorized by section 14(e).

Sufficient support, it seems, may be drawn only from an additional determination of the extent to which the Court's rationale undergirding its decision to apply Rule 14e-3 to *O'Hagan*-type misappropriation logically can be carried over to the warehousing scenario. The context of this analysis can be summarized as follows: As applied to the nature and extent of both deception and nondisclosure inherent in warehousing activity, is the prohibition of warehousing under Rule 14e-3 valid given section 14(e)'s limitation of "means reasonably designed to prevent . . . acts and practices" that are "fraudulent"?⁸⁶ More specifically: How does the nature and extent of deception and nondisclosure inherent in warehousing activity implicate the traditional policy concerns of fairness and market integrity that surround insider trading law?⁸⁷

86. See *supra* note 75 and accompanying text (reciting authorization language of section 14(e)).

87. See generally Swanson, *supra* note 3, at 1159-60 (discussing the policy concerns inherent in insider trading law). This Note does not deal with a third concern, market efficiency, as it does not directly implicate fraud, deception, or nondisclosure. Market efficiency, however, is an interesting and often controversial aspect of insider trading law and policy. See generally Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 866-72 (1983) (arguing that insider trading may be desirable based on market efficiency goals); Boyd Kimball Dyer, *Economic Analysis, Insider Trading, and Game Markets*, 1992 UTAH L. REV. 1, 11-66 (exploring economic arguments supporting the prohibition against insider trading); Swanson, *supra* note 3, at 1206 ("Economists advance a convincing case that insider trading in fact enhances market efficiency, negating the need for any prohibition. Even if the efficiency argument were only marginal, the enforcement costs would tip the balance away from regulation.").

Not all commentators, however, agree that insider trading necessarily creates market efficiency, and still others believe the efficiency of insider trading to be an irrelevant consideration. See Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 1992 DUKE L.J. 977, 1003 (noting that a repeal of the insider trading prohibition would have little effect in reducing market volatility); Olson et al., *supra* note 35, at 227-29; Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1439 (1967) ("Even if . . . unfettered insider trading would bring an economic gain, we might still forego that gain in order to secure a stock market . . . that satisfies] such noneconomic goals as fairness, just rewards and integrity.").

Warehousing: Deception and Nondisclosure, Fairness, and Market Integrity

As mentioned above, simply making the determination that warehousing is distinct from *O'Hagan*-type misappropriation is insufficient to support a claim that warehousing must therefore fall outside of the legitimate prophylactic scope of Rule 14e-3.⁸⁸ The differences between the two activities, however, are helpful in highlighting the overriding concerns that support section 14(e), as well as Rule 14e-3 and its expansive prophylactic scope.⁸⁹ By analyzing the distinctions delineated above, under the interrelated notions of fairness and market integrity,⁹⁰ this Note argues that the practice of warehousing does not implicate either of these concerns to an extent sufficient to fall within Rule 14e-3's prophylactic scope, as authorized by section 14(e) and interpreted by the Court in *O'Hagan*.

Within the following analysis, it is essential to understand that this Note does not presume that negative issues surrounding fairness and market integrity are absent in the warehousing context. This discussion instead focuses on the nature and extent of deception and nondisclosure exhibited in the warehousing practice and asks whether it is sufficient to justify warehousing's legitimate prohibition under Rule 14e-3, in light of the concerns of fairness and market integrity, and given the Court's opinion in *O'Hagan*.

88. See *supra* notes 58-73 and accompanying text (discussing warehousing and misappropriation).

89. See *supra* notes 30-31 and accompanying text (discussing the necessity of Rule 14e-3's prophylactic reach); see also *supra* note 87 and accompanying text (discussing "fairness" and "market efficiency").

90. For an excellent and readily understandable analysis of the notions of fairness and integrity as they relate specifically to the various antifraud provisions of the Exchange Act, see Olson et al., *supra* note 35, at 226-29. Numerous other, more in-depth treatments of the subject exist, as evidenced by the observation by one commentator that "[m]any forests have been destroyed in the quest to understand and explain the law of insider trading." Lawrence E. Mitchell, *The Jurisprudence of the Misappropriation Theory and the New Insider Trading Legislation: From Fairness to Efficiency and Back*, 52 ALB. L. REV. 775, 775 (1988).

Fairness

The Court's concern with deception and nondisclosure in *O'Hagan* can be justified as an extension of the more fundamental concern of fairness.⁹¹ That misappropriation of nonpublic information, leading to tender offer trading activity, implicates fairness seems obvious. Following the Court's decision in *O'Hagan*, it also seems clear that misappropriation, an activity short of actual fraud, can be so unfair as to fall under the prophylactic arm of Rule 14e-3.⁹² This conclusion, however, begs the question: What makes a particular nonfraudulent trading activity so unfair as to allow for its prohibition under a tender offer insider trading provision that speaks only of the prohibition of fraudulent activity?⁹³

Fairness, though nearly always mentioned in a treatment of insider trading law,⁹⁴ is an extremely elusive concept to define, leading one commentator simply to refer to the notion as "gut-reaction fairness."⁹⁵ One certainty, however, is that a meaningful

91. It is important to note that "fairness," as used within this discussion, is necessarily distinct from the issue of "fraud." In examining the prophylactic scope of Rule 14e-3, traditional or common-law fraud is no longer at issue; rather, it is the more elusive determination of fairness that drives the purely prophylactic arm of Rule 14e-3. See generally Cook, *supra* note 11, at 204-06 (discussing the fairness rationale in the context of Rule 14e-3).

92. See *supra* notes 30-31 and accompanying text.

93. See *supra* note 75 and accompanying text (reciting section 14(e)); see also *supra* note 78 (noting the definitional equivalence of the terms "fraudulent," "deceptive," and "manipulative").

94. See, e.g., Carlton & Fischel, *supra* note 87, at 880-82 (discussing fairness arguments); Dalley, *supra* note 2, at 1339-43 (considering fairness and standards of the business community); Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 219-26 (1991) (discussing fairness as a basis for insider trading prohibitions); Salbu, *supra* note 4, at 249 (noting fairness arguments); Kim Lane Scheppele, "It's Just Not Right": *The Ethics of Insider Trading*, LAW & CONTEMP. PROBS., Summer 1993, at 123, 160-63 (arguing in favor of the need for a level playing field); Cook, *supra* note 11, at 204-06 (discussing the fairness theory behind the ban on insider trading); David A. Wilson, Note and Comment, *Outsider Trading—Morality and the Law of Securities Fraud*, 77 GEO. L.J. 181, 212-16 (1988) (detailing the "fair play obligation").

95. Swanson, *supra* note 3, at 1210. Another commentator illustrates the notion of fairness within insider trading by relating it to the popular mentality that "[t]he successful inside trader has won the lottery without buying a ticket." Fisch, *supra* note 94, at 233.

evaluation of fairness in the field of securities regulation must involve an assessment of an activity's equity in reference to some individual or group, most importantly the party or parties impacted by that activity, rather than being based purely upon metaphysical theory.⁹⁶

The fairness issue evaluated by the Court in *O'Hagan* involved fairness to the *corporate source* of the inside information.⁹⁷ The essence of the misappropriation theory is that it is unfair—an inequity nearing fraudulence—for an investor, through deceptive nondisclosure to the source, to profit from inside information intended solely for a corporate purpose.⁹⁸ This type of unfairness does not exist in the warehousing scenario, however, in which the tipping of inside information involves no deception to the corporation, and in fact serves the corporate purpose.⁹⁹ This level of inequity, then, cannot be carried over from the *O'Hagan*-type of tender offer trading activity to warehousing.

The question that remains is whether the practice of warehousing implicates unfairness vis-a-vis another party; in this case, the other party could only be the selling shareholders of the target corporation. In the warehousing context, determining if deception occurs as a result of the trader failing to reveal nonpublic information is central to the evaluation of warehousing and its relationship to both fairness and market integrity. The very method by which the securities markets function, however, creates a situation in which pinpointing any specific deception is impractical, if not impossible.¹⁰⁰

96. See Fisch, *supra* note 94, at 220-21 (noting that an inequality of information, whether resulting in direct or indirect harm, is the basis of the fairness argument).

97. See *supra* note 41 and accompanying text.

98. See *supra* note 40 and accompanying text.

99. See *supra* note 51 and accompanying text.

100. See SEC v. Jakubowski, 150 F.3d 675, 679-80 (7th Cir. 1998) (Easterbrook, J.) (analyzing the Court's decision in *O'Hagan* by stating that "[a]lthough O'Hagan had private information about the future price of the stock, he did not deceive the investors by trading at the market price O'Hagan's actions wronged the bidder, not the persons from whom he bought stock" (emphasis added)); Dalley, *supra* note 2, at 1349 ("The fact that insider trading occurs primarily in an impersonal market is probably most significant in that it makes the ignorant trader's loss difficult to identify.").

The securities markets operate in an anonymous manner; as such, traders do not typically carry out face-to-face bargaining.¹⁰¹ In fact, in the typical market transaction, no bargaining takes place at all.¹⁰² Traders make decisions to purchase securities at a certain price, and decisions to sell securities at the same price, completely independent of one another. Within the securities markets, the motivation to buy or sell at any given price is unique to each individual trader, and thus traders make individual trading judgments quite apart from any concept of deception or unfairness.¹⁰³ Perhaps, then, the unfairness within warehousing can be viewed as against a much larger party in interest; namely, the market in general, and its participating investors. Under these circumstances, the notion of fairness is addressed more properly under the related notions of market integrity and equality of information.

Market Integrity

A related manner in which to view the notion of fairness involves equating fairness with "assuring market integrity so that the average investor will have the confidence to participate."¹⁰⁴ The market integrity argument emanates from the notion that permitting traders with inside information to participate in market trades, when other traders lack the same nonpublic information, essentially creates a "rigged" situation that, by undermining public confidence in the capital markets, will drive ordinary investors away from future participation.¹⁰⁵ To the extent that the equity, or the lack thereof, involved in this notion is equated

101. See Dalley, *supra* note 2, at 1347-51 (discussing the characteristics of the "Impersonal Stock Market").

102. See Scheppele, *supra* note 94, at 138 ("[B]uyers and sellers are not present [in market trades] as concrete individuals with complex particular understandings about the terms of the sale; they are abstracted entities who respond *only* to the terms of the market-price predominantly" (emphasis added)).

103. See *id.*; Stephanie F. Barkholz, Comment, *Insider Trading, the Contemporaneous Trader, and the Corporate Acquirer: Entitlement to Profits Disgorged by the SEC*, 40 EMORY L.J. 537, 546-56 (1991) (discussing the rights of contemporaneous traders to recover profits and concluding that there is no causal connection that would allow recovery).

104. Swanson, *supra* note 3, at 1206.

105. See Carlton & Fischel, *supra* note 87, at 858; Swanson, *supra* note 3, at 1161.

with informational egalitarianism,¹⁰⁶ it is unattainable and unrealistic outside of a theoretical vacuum, given the informational advantages that many market participants and investors already possess.¹⁰⁷ Once the government and the courts tolerate some inequality of investor information, the equality of information theory¹⁰⁸ carries little weight as the basis for establishing the inequity of utilizing insider information.¹⁰⁹ Additionally, one hardly can argue that investors presently are unaware of the existence of insider trading, negating the claim that investors are being exploited unknowingly.¹¹⁰ Thus the fact that some investors may possess more information than others, although potentially unfair in some sense of the word, does not create a situation in which fraud and deception are inherent within the securities market.¹¹¹

Scholars have argued that the deception involved in the use of inside information can be highlighted best, not by following an equality of information model, but rather by employing an

106. Informational egalitarianism assumes all traders have an equal amount of market information. See Swanson, *supra* note 3, at 1161-62.

107. See *id.* Market professionals, in particular, make a living by conducting extensive in-house research, and by acquiring, often through established corporate insider contacts, information that few ordinary market investors are able to obtain. See L. Gordon Crovitz, *With 'Insider Trading,' It's Conviction First-Definition Later*, WALL ST. J., May 9, 1990, at A15 (noting that "[f]orced equality of information is an odd idea in an industry with legions of analysts paid to ferret out information and where Moms and Pops pay mutual funds to watch markets for them").

The disparity of access to and amount of available information is especially evident in the search for potential corporate targets and takeovers. See generally James Harlan Koenig, Comment, *The Basics of Disclosure: The Market for Information in the Market for Corporate Control*, 43 U. MIAMI L. REV. 1021, 1027-38 (1989) (discussing information available in the context of corporate mergers and acquisitions).

108. The Supreme Court has noted that "neither the Congress nor the [SEC] ever has adopted a parity-of-information rule." *United States v. Chiarella*, 445 U.S. 222, 233 (1980).

109. See Garten, *supra* note 51, at 612.

110. See Carlton & Fischel, *supra* note 87, at 879-80 (discussing the reasons uninformed traders trade in the stock market); see also Barkholz, *supra* note 103, at 567 ("Incomplete information is a constant 'risk' in the market, and its possible harm to the trader is present even in the absence of insider trading."); Haskell, *supra* note 19, at 243 ("[A] parity-of-information rule does little to affect the confidences of investors as reflected in their investment practices.").

111. See Barkholz, *supra* note 103, at 567 (concluding that the harm caused by unequal information is a risk of trading even without insider trading).

equality of *access* to information model.¹¹² This notion is based on a view of fairness that seeks to achieve a general consent to established rules under which the benefits and losses of securities trading will take place.¹¹³ Under this theory, an investor who trades on inside information offends these established rules because other investors, who have no possibility of obtaining the identical information, would not consent to the trading activity.¹¹⁴ Although this distinction may enable a more lucid determination as to the theoretical equity of insider trading transactions to be made, the following illustration will show that the distinction is meaningless, at least within the context of market integrity, and specifically as it pertains to warehousing.

In the case of a tender offer, pre-initiation increases of the securities price of the target corporation often can be attributed to legitimate information searches, as well as to exploitations of leaks,¹¹⁵ or direct divulgence of inside information.¹¹⁶ To the seller of securities, who cannot feasibly know either the purchaser or the purchaser's rationale for purchasing on the open market,¹¹⁷ it is irrelevant whether the purchaser chooses to buy certain securities at a certain price based upon research, a hunch, or a tip from the inside.¹¹⁸ Additionally, we cannot logically conclude that the tippee is, in effect, "stealing" part of the return in market value from traders who have made a unilateral decision to sell, especially in light of the fact that what the seller is actually losing, if anything, is merely the potential of a takeover premium.¹¹⁹ Even when that potential is of significant magnitude, it

112. See Scheppele, *supra* note 94, at 125 (explaining why fiduciary obligation analysis is insufficient to decide insider trading cases).

113. See *id.* at 155 (discussing the contractarian approach to obligations between trading partners).

114. See *id.* at 162-63 (explaining how the moral concept of equal access to information justifies rules on insider trading).

115. See Pitt et al., *supra* note 3, at 75 (noting that "[d]espite everyone's best efforts, putative tender offers often become the source of marketplace rumors").

116. See Salbu, *supra* note 4, at 234-35.

117. See *supra* notes 100-02 and accompanying text.

118. See Fisch, *supra* note 94, at 197 (observing that "stockholders who decided contemporaneously to sell did so based on extraneous factors . . . [making] a decision they would have made even if the insiders had stayed out of the market").

119. The premium is merely potential because there is no guarantee that a tender offer actually will be initiated; furthermore, even once initiated, the tender offer may

is essential to recall that the seller has in no way been forced, by deception or otherwise, to sell; an investor in this situation always possesses the option of simply not trading.¹²⁰ Ultimately, market integrity relies on the absence of fraud and deception;¹²¹ the integrity of the securities markets cannot be predicated on the absence and elimination of all access to information, including warehousing, deemed merely unfair.¹²²

Although the warehousing situation described above likely creates a sense that something unfair is taking place, it is quite a different story to determine that either a fraudulent activity or a deceptive act prohibited by post-*O'Hagan* Rule 14e-3 has occurred. To accept that the practice of warehousing legitimately violates the mandate of section 14(e), one must first conclude that the unfairness within warehousing trading activity implicates an inequity against the market in general that rises, at a minimum, to the level of *O'Hagan*-type misappropriation, and thus that market integrity is at stake.¹²³ The Court in *O'Hagan*, however, emphasized that the activity being prevented under the mandate of section 14(e) is fraud or misappropriation on the source of the nonpublic information.¹²⁴ Within the practice of warehousing, the degree of unfairness involved simply does not rise even to *O'Hagan*-type levels.

SECTION 14(e): THE ROLE OF THE COURT AND THE CONGRESS

"The history of the rule against insider trading has been a search for a legal theory to justify why conduct that is wrong is

fail, or be revoked by the bidder.

120. See Nicholas L. Georgakopoulos, *Insider Trading as a Transactional Cost: A Market Micro Structure Justification and Optimization of Insider Trading Regulation*, 26 CONN. L. REV. 1, 17 (1993) (stating that uninformed traders can avoid having informed traders "take" stock market returns simply by not trading).

121. "Deception" here means the type exhibited in *O'Hagan*. See *supra* notes 38-41 and accompanying text.

122. See Scheppele, *supra* note 94, at 125.

123. This, of course, is the opposite of the conclusion just reached. See *supra* notes 91-122 and accompanying text.

124. See *supra* note 41 and accompanying text; see also Pitt et al., *supra* note 3, at 77 (interpreting the *O'Hagan* decision as standing for the proposition that "a defendant deceives nobody and is not subject to liability if the insider trading has been disclosed to a principal and consent was obtained").

also illegal."¹²⁵ Applied to the specific context of the tender offer, and even more specifically to the practice of warehousing, this quotation directly addresses the tension surrounding much of the debate over Rule 14e-3 in the wake of the *O'Hagan* decision. As for the fairness justification, and the related justification of market integrity, this Note maintains that *not* all inappropriate, or even immoral, activity need necessarily be equated legally with fraud or even *O'Hagan*-type misappropriation.¹²⁶ Ethical considerations may be made apart from legal conclusions. Perhaps lost in much of the discussion is the specific goal of section 14(e) as interpreted by the Court in *O'Hagan*; the activity being proscribed within the tender offer context by Rule 14e-3 is *fraudulent activity, and those activities so akin to fraud as to fall within Rule 14e-3's prophylactic reach*.¹²⁷ As is true of all other areas of the law, but especially within the controversial realm of insider trading, it is worth another reminder that not all unethical or unfair activity necessarily is unlawful, fraudulent, or, in the situation of Rule 14e-3, even within the relevant scope of fraud.¹²⁸

In the future, the role of the Court, in evaluating the practice of warehousing, will be to view the activity within the framework of section 14(e)'s authorizing provision, in light of the prophylactic scope of Rule 14e-3 as interpreted in *O'Hagan*. In addition, it is important to remember that, ultimately, section 14(e) deals with the prevention of *fraud* according to the framework established by Congress.¹²⁹ Based on the Court's analysis of activity legitimately prohibited by Rule 14e-3 and its prophylactic extension,¹³⁰ and in light of the significant distinctions between *O'Hagan*-type misappropriation and warehousing,¹³¹ it is neither

125. Garten, *supra* note 51, at 612.

126. See *supra* text accompanying note 82; see also *United States v. O'Hagan*, 92 F.3d 612, 628 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997) (noting that "it is a fundamental principle of the criminal law that not every ethical or moral transgression falls within its realm").

127. See *supra* notes 30-31 and accompanying text.

128. See *supra* notes 91-92 and accompanying text (noting that "fairness" is distinct from common-law fraud in the Rule 14e-3 context).

129. See *supra* note 75 and accompanying text.

130. See *supra* notes 30-31 and accompanying text.

131. See generally *supra* notes 58-124 and accompanying text (discussing the corre-

logical nor proper for the Court to place warehousing activity within the same prophylactic scope. It is not the domain of the judiciary to make determinations concerning the point at which unfair activity becomes legally fraudulent; a policy determination of this nature is best left to Congress.¹³² By ruling that warehousing is not properly proscribed by Rule 14e-3 under section 14(e), the Court effectively will defer this critical policy determination to Congress, which, if so inclined, may enact more specific legislation targeting the type of nonfraudulent tender offer trading activity that occurs in warehousing.¹³³

CONCLUSION

In *United States v. O'Hagan*, the Supreme Court sustained the validity of SEC Rule 14e-3 by focusing on the rule's prophylactic nature. By failing to delineate clearly the limits of Rule 14e-3's prophylactic scope, however, the Court left unresolved questions concerning the legitimacy of the rule as applied to the practice of warehousing. By concentrating on the limiting language used by the Court in its Rule 14e-3 analysis in *O'Hagan*, examining the specific use of the term "misappropriation" within the Rule 10b-5 context, and applying the *O'Hagan* principles of misappropriation to Rule 14e-3, this Note has established several significant distinctions between the tender offer trading activity exhibited in *O'Hagan* and the tender offer trading activity involved in the practice of warehousing.

By exploring these distinctions—most significantly the nature and extent of deception through nondisclosure to the source of the nonpublic information—under the notions of fairness, market integrity, and equality of information, this Note, in light of section 14(e)'s mandate to prevent fraudulent acts, concludes

lation between warehousing and misappropriation).

132. See Painter et al., *supra* note 3, at 211-18 (arguing for Congress or the SEC to define when it is illegal to trade on the basis of material, nonpublic information).

133. See Fisch, *supra* note 94, at 228-35 (discussing the political reasons behind insider trading laws); Swanson, *supra* note 3, at 1208 (stating that if Bryan and *O'Hagan* were the law today, the government would urge Congress "for more specific legislation"); Jonathan E.A. ten Oever, Case Note, *Insider Trading and the Dual Role of Information*, 106 YALE L.J. 1325, 1328-30 (1997) (arguing for congressional enactment of legislation based upon the recognition of the "dual role" of information).

that the prophylactic reach of SEC Rule 14e-3 should not legitimately prohibit warehousing. Put succinctly, not only is warehousing distinct from misappropriation in several key aspects, but additionally the type of unfairness involved in the practice of warehousing simply does not rise to the level legitimately prohibited under Rule 14e-3's prophylactic scope.

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