

NOTE

United States v. O'Hagan: A Failed Attempt to Protect Public Policies Underlying the Securities Laws

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INTRODUCTION

Congress enacted the United States securities laws¹ to promote fair and honest capital markets² and to establish investor confidence.³ Congress's purpose was to erect an efficient market to allocate resources, minimize borrower costs of capital, and adjust prices to reflect value accurately.⁴ Insider⁵ trading, the practice of using material nonpublic information when buying or selling securities, is harmful to an efficient market because it destroys investor confidence.⁶ Recognizing this, Congress applauded the Securities and Exchange Commission's ("SEC") efforts to restrict insider trading.⁷ The Supreme Court's recent decision in *United States v. O'Hagan*,⁸ however, creates a defense to insider trading which fails to respect the policies underlying the securities laws.⁹

¹ This Note limits the analysis of securities laws to the 1933 Act and 1934 Act. The term "security" is defined separately in both Acts. See 15 U.S.C. § 77b(1) (1994); 15 U.S.C. § 78c(a)(10-12) (1994). For a thorough discussion of problems associated with the definition of a security, see generally 1 THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 1.5 (2d ed. 1990) (listing various types of securities).

² See 15 U.S.C. § 78b.

³ See 45 Fed. Reg. 60,412 (1980) (explaining that insider trading undermines investor confidence in securities markets).

⁴ See Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 334-35 (1979) (noting that flow of information is means to market efficiency).

⁵ The term "insider" has traditionally referred to persons within a corporation that, because of their relationship to shareholders, have a fiduciary duty to abstain from trading securities under certain circumstances. See, e.g., *United States v. O'Hagan*, 521 U.S. 642, 651 (1997). The term has also expanded to include other persons that are restricted from trading under the securities laws. See Edward Felsenthal, *Big Weapon Against Insider Trading Is Upheld*, WALL ST. J., June 16, 1997, at C1 (describing stock traders who obtain nonpublic information but are not company insiders as coming within misappropriation theory's prohibition of insider trading).

⁶ See 2 HAZEN, *supra* note 1, § 12.1. Insider trading is not specifically defined in federal legislation. See Manning Gilbert Warren III, *A Foreword on Insider Trading Regulation*, 39 ALA. L. REV. 337, 337 (1988). However, for introductory purposes, a workable definition is found in the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 [hereinafter ITSFEA] (codified in scattered sections of 15 U.S.C.). Section 2(1) of ITSFEA refers to the SEC's rules governing "trading while in possession of material nonpublic information" in the introductory language. *Id.* Within an entire law review issue devoted to the problems of defining insider trading, one author jokingly urged Congress to simply enact a statute mandating that "it shall be unlawful" and to allow the SEC to define it. See Homer Krimke, *A Note on Insider Trading: An Example of How Not to Make Law*, 39 ALA. L. REV. 349, 350 (1988).

⁷ See ITSFEA, *supra* note 6 (noting that SEC rules and regulations governing trading while in possession of material nonpublic information are necessary in public interest and for investor protection).

⁸ 521 U.S. at 642.

⁹ See *id.* at 655 (allowing trading on material nonpublic information after disclosure to

After *O'Hagan*, an investor may gain access to a company's confidential information and lawfully trade securities so long as he merely discloses his plan to that company.¹⁰ For example, suppose one company plans to acquire another. As soon as the acquiring company publicly announces the plan, the price of the target company's stock may rise significantly. Before the public announcement, however, the acquiring company might provide valuable information about the takeover plan to an outside individual, such as a consultant, in exchange for advice on an altogether different matter. Further, the acquiring company could give the consultant permission to use the valuable information when purchasing securities in the open market. This information, and the accompanying permission to use it when trading, serves as compensation for services. More importantly, the information gives the consultant an advantage over others when trading the target company's securities before the information becomes public. While the acquiring company is not harmed in these transactions,¹¹ the investor selling the target company's securities, not privy to the otherwise confidential information, sells the securities to the "insider" at a price he has no idea is too low.¹² This is not consonant with the Congressional purpose underlying the securities laws. However, the *O'Hagan* Court condones it.¹³

This Note criticizes the *O'Hagan* decision and proposes an alternative solution. Part I discusses the United States securities laws and their underlying public policies, as well as insider trading

information source).

¹⁰ See *id.* (explaining that full disclosure to source forecloses liability under misappropriation theory because disclosure negates "deceptive device" requirement).

¹¹ The acquiring company is not harmed because it cannot acquire a significant portion of the target company before public disclosure and, thus, they cannot buy much stock below the final purchase price. See 17 C.F.R. § 240.13d-1 to -6 (1998) (preventing acquiring company from having more than five percent of target before making its actions public); PATRICK A. GAUGHAN, *MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS* 57 (1996). Once the acquiring company makes its actions public, the price of the target company's stock will usually rise, thereby increasing the price that the acquirer must pay. See *id.* In fact, the acquiring company has an incentive to pursue an arrangement like this if the person will sell the stock back at a price less than the final purchase price. See *id.* (noting that stock parking, although illegal, is great economic incentive).

¹² Opposing traders automatically lose because they sell securities at a low price when the information, if known, would allow them to sell at a higher price. See *Chiarella v. United States*, 445 U.S. 222, 241 (1980) (Burger, C.J., dissenting) (noting that person acquiring securities with undue information advantage gains profits at expense of others).

¹³ See 521 U.S. at 642 (holding that disclosure to source forecloses liability under misappropriation theory); see also *id.* at 689 (Thomas, J., dissenting) (noting that majority's analysis precludes liability when source expressly authorizes trading).

theories. Part II presents the *O'Hagan* case and examines the majority's rationale. Part III analyzes the majority's decision and proposes an alternative theory for O'Hagan's conviction that more adequately supports public policy. The proposed theory prohibits trading when material information is not equally accessible to all investors.

I. INTRODUCTION TO SECURITIES LAWS

On October 29, 1929, the United States stock market crashed.¹⁴ Known as Black Monday,¹⁵ the crash marked the beginning of the Great Depression and was the impetus for the federal securities laws.¹⁶ Congress responded to the crash by enacting two landmark pieces of legislation: the Securities Act of 1933 ("1933 Act")¹⁷ and the Securities Exchange Act of 1934 ("1934 Act").¹⁸

A. *The Securities Act of 1933*

Throughout the decade following World War I, lax securities laws allowed unscrupulous promoters to issue stock without providing information that investors needed to determine the value of their investments.¹⁹ Half of the fifty billion dollars of securities issued during this period proved worthless.²⁰ Accordingly, President Roosevelt called on Congress to enact legislation to remedy this problem.²¹

¹⁴ See Laura K. Bancroft, Note, *Gustafson v. Alloyd Co.: The Continued Shrinking of Private-Plaintiff Remedies Under the 1933 Securities Act*, 27 LOY. U. CHI. L.J. 149, 152 (1995).

¹⁵ See *id.*

¹⁶ See *O'Hagan*, 521 U.S. at 642; Cristy B. Bell, *Investor Protection After McMahon: The Arbitrability of Claims Arising Under Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5*, 13 DEL. J. CORP. L. 537, 541 (1988); Joseph E. Reece, *Would Someone Please Tell Me the Definition of the Term "Seller": The Confusion Surrounding Section 12(2) of the Securities Act of 1933*, 14 DEL. J. CORP. L. 35, 38 (1989).

¹⁷ 15 U.S.C. § 77a to aa (1994).

¹⁸ 15 U.S.C. § 78a to ll (1994).

¹⁹ See H.R. REP. NO. 85 (1933), reprinted in JAMES D. COX ET AL., *SECURITIES REGULATION* 3 (1997) (describing absence of fair dealing standards for securities underwriters as reason for issuance of worthless securities). The information provided to investors today includes a thorough description of the issuer's business and management. See 1 HAZEN, *supra* note 1, § 3.7.

²⁰ See COX ET AL., *supra* note 19, at 3.

²¹ See 77 CONG. REC. 937 (1933), reprinted in FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, 1 FEDERAL SECURITIES LAWS: LEGISLATIVE HISTORY 1933-1982, at 20 (1983) (recommending legislation to protect investors and return public confidence after public sustained severe losses through dishonest practices of securities sellers); see also Cheryl Goss Weiss, *A Review of the Historic Foundations of Broker — Dealer Liability for Breach of Fiduciary Duty*,

Congress responded by enacting the 1933 Act.²² The 1933 Act requires companies planning to issue new securities to register the offering with the SEC.²³ By registering an offering, the company provides potential investors with specific information contained in a prospectus.²⁴ The purposes of the 1933 Act include protecting investors, preventing public exploitation via the sale of worthless securities, improving the economy, and improving the confidence of the investing public.²⁵ The 1933 Act achieves these goals by requiring companies to provide timely, sufficient, reliable, and material information regarding the value of the securities they offer for sale.²⁶ However, the 1933 Act addressed none of the problems associated with the subsequent trading of such securities occurring in the stock market.²⁷

B. *The Securities Exchange Act of 1934*

The 1934 Act governs the purchase and sale of previously issued securities.²⁸ Among other things, the 1934 Act addresses such trading problems as speculation,²⁹ margin requirements,³⁰ price manipulation,³¹ and deception.³² The 1934 Act's main provision

23 J. CORP. L. 65, 85 (1997) (noting Roosevelt administration's proposed 1933 securities reform as part of New Deal).

²² See Bancroft, *supra* note 14, at 152.

²³ See 15 U.S.C. § 77e (1994) (prohibiting sale of securities in interstate commerce channels unless registration statement is in effect). The SEC is the federal agency responsible for administering the federal securities laws. See 1 HAZEN, *supra* note 1, § 1.3.

²⁴ See 1 HAZEN, *supra* note 1, §§ 3.1-2 (noting that companies generally provide description of company, certified financial statements, and description of offered securities in prospectus). A prospectus is a document that contains information about the issuer and is designed to provide investors with information needed to evaluate the worth of offered securities. See *id.* § 3.1.

²⁵ See Bell, *supra* note 16, at 541-42 & nn.35-36.

²⁶ See *id.*

²⁷ See *infra* notes 29-32 and accompanying text (noting problems of speculation, margin requirements, price manipulation, and deception).

²⁸ See 15 U.S.C. § 78b (1994); see also Bell, *supra* note 16, at 542.

²⁹ See 15 U.S.C. § 78b(3); see also, COX ET AL., *supra* note 19, at 5 (noting that speculation in stocks was akin to national pastime which drove stock market to unwarranted pre-crash valuations, thus contributing to Great Depression).

³⁰ See 15 U.S.C. § 78g. Allowing securities to be purchased on margin means that an investor borrows money to purchase securities. See COX ET AL., *supra* note 19, at 5-6 (noting that when stock prices fell, lenders required payment and investors sold stock to cover payments, which led to chain reaction of falling prices).

³¹ See 15 U.S.C. § 78i. Pools of greedy brokers and dealers created the appearance of increased demand for particular stocks by buying and selling to one another and, thus, manipulated prices. See COX ET AL., *supra* note 19, at 6. Pools create an impression that the stock is attractive and induce other investors to buy stock, while the pool participants sell at

proscribing deception is section 10(b).³³ Section 10(b) prohibits manipulative or deceptive acts when buying or selling securities.³⁴ This section also grants the SEC authority to promulgate rules "for the protection of investors."³⁵ Pursuant to this authority, the SEC adopted Rule 10b-5 in 1942.³⁶ The rule prohibits the use of fraudulent schemes,³⁷ misleading statements and omissions,³⁸ and deceitful practices³⁹ when buying or selling securities.⁴⁰

Now, decades after its adoption, Rule 10b-5 is the SEC's primary weapon against insider trading.⁴¹ Yet, neither section 10(b) nor Rule 10b-5 specifically mention insider trading.⁴² The prohibition of insider trading under these provisions has evolved through case law into two mutually exclusive theories: the classical theory and the misappropriation theory.⁴³

inflated prices. *See id.*

³³ See 15 U.S.C. § 78j. Deception in this context generally refers to the dissemination of false or misleading information. *See COX ET AL., supra* note 19, at 6.

³⁴ See 15 U.S.C. § 78j(b); *see also COX ET AL., supra* note 19, at 681-82 (noting interrelationship of section 10(b) and Rule 10b-5 and their importance in proscribing deception).

³⁵ See 15 U.S.C. § 78j(b).

³⁶ *Id.*; *see also United States v. O'Hagan*, 521 U.S. 642, 651 (1997) (noting that SEC adopted Rule 10b-5 pursuant to rulemaking authority under section 10(b)). Another example of a rule adopted by the SEC under this authority is Rule 10b-3. *See* 17 C.F.R. § 240.10b-3 (1997) (prohibiting deception by brokers or dealers).

³⁷ See 17 C.F.R. § 240.10b-5; *see also COX ET AL., supra* note 19, at 681-82 (noting that legislators drafted Rule 10b-5 to extend antifraud protection to sellers in response to insider who disseminated pessimistic information to buy securities at bargain prices).

³⁸ See 17 C.F.R. § 240.10b-5(a) (prohibiting use of any scheme to defraud); *see also Richardson v. MacArthur*, 451 F.2d 35, 40 (10th Cir. 1971) (noting that section 10(b) is not limited to deceit regarding price, but rather prohibits all fraudulent schemes in connection with purchase and sale of securities).

³⁹ See 17 C.F.R. § 240.10b-5(b) (prohibiting untrue statements of material facts and omissions that are necessary to make prior statements no longer misleading); *see also SEC v. Jakubowski*, 912 F. Supp. 1073, 1079 (N.D. Ill. 1996) (noting that for 10b-5 liability SEC must prove making of untrue statement of fact or omitting fact when duty to speak exists).

⁴⁰ See 17 C.F.R. § 240.10b-5(c) (prohibiting any act, practice, or course of business that operates as fraud or deceit upon any person); *see also Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 9 (1971) (finding act or practice that operated as fraud or deceit when buyer duped seller into believing he would receive proceeds from sale of securities).

⁴¹ See 17 C.F.R. § 240.10b-5; *see also* 15 U.S.C. § 78c(13)-(14) (1994) (defining terms "buy" and "sell" to include any contract to buy and sell).

⁴² See 2 HAZEN, *supra* note 1, § 12.1 (describing Rule 10b-5 as centerpiece of antifraud laws).

⁴³ See 15 U.S.C. § 78j (1994); 17 C.F.R. § 240.10b-5; *see also Daniel L. Goelzer, Introduction to Symposium on Insider Trading*, 13 HOFSTRA L. REV. 1, 1-2 (1984) (noting that insider trading liability has grown out of antifraud provisions of securities laws).

⁴⁴ See *infra* notes 44-86 and accompanying text (discussing development of insider trading law in courts).

1. Development of the Classical Theory of Insider Trading

The first major case using Rule 10b-5 to address insider trading was the SEC's 1961 decision, *In re Cady, Roberts & Co.*⁴⁴ J. Cheever Cowdin, a representative of the Cady Roberts brokerage firm, was also a director of the Curtiss-Wright Corporation.⁴⁵ At a Curtiss-Wright directors meeting, the directors voted to reduce the dividend. Before Curtiss-Wright announced this information to the public, Cowdin informed Robert Gintel, another broker at Cady Roberts, of the vote.⁴⁶ Gintel subsequently sold Curtiss-Wright stock before the corporation publicly announced the dividend reduction, preventing a substantial loss on his investment.⁴⁷ The SEC found a violation of Rule 10b-5 in an administrative hearing.⁴⁸

The SEC based its decision in *Cady Roberts* on two principles.⁴⁹ First, the SEC determined that the relationship between Cowdin and Curtiss-Wright gave Cowdin access to information intended only for a corporate purpose, and not for personal gain.⁵⁰ This relationship extended to Gintel, thereby prohibiting him from personally benefiting from this information.⁵¹ Second, the SEC found that it was inherently unfair for one party to use corporate information knowing the information was unavailable to other traders.⁵² Because other traders would have acted differently if they had known of the dividend reduction, Gintel had an unfair trading advantage.⁵³

Seven years later, in *SEC v. Texas Gulf Sulphur Co.*,⁵⁴ the Second Circuit expanded the SEC's insider trading analysis.⁵⁵ In *Texas*

⁴⁴ 40 S.E.C. 907 (1961); see also CHARLES R. O'KELLY, JR. & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: CASES AND MATERIALS 1232 (2d ed. 1996) (noting importance of *Cady Roberts* as first step in use of Rule 10b-5 to regulate insider trading).

⁴⁵ See *Cady Roberts*, 40 S.E.C. at 909.

⁴⁶ See *id.* at 908-09.

⁴⁷ See *id.* at 909.

⁴⁸ See *id.* at 912, 917-18 (arguing that prohibition on trading by Cowdin extends to Gintel and describing administrative order against Gintel).

⁴⁹ See *id.* at 912.

⁵⁰ See *id.*

⁵¹ See *id.* (noting that relationship prohibits broker from selling for his own account as well as for clients).

⁵² See *id.*

⁵³ See *id.* at 914 (arguing that investment judgment would be affected if buyers knew sellers' information).

⁵⁴ 401 F.2d 833 (2d Cir. 1968).

⁵⁵ See COX ET AL., *supra* note 19, at 775-76 (describing *Texas Gulf Sulphur* as landmark case enlarging Rule 10b-5's coverage).

Gulf, the court held that corporate insiders must publicly disclose material inside information or refrain from trading.⁵⁶ The court reasoned that all traders deserve relatively equal access to material information.⁵⁷

Twelve years after *Texas Gulf*, the Supreme Court decided *Chiarella v. United States*, the first section 10(b) case, in which the Court altered the focus of insider trading analysis.⁵⁸ In *Chiarella* the Court stated that silence may operate as a fraud under section 10(b).⁵⁹ However, liability results only when there is an affirmative duty to disclose information.⁶⁰ This duty arises from a relationship of trust and confidence between parties to a transaction.⁶¹ One such relationship exists between corporate officers and directors (insiders) and the corporation's shareholders.⁶² In *Chiarella* this relationship did not exist.⁶³

Vincent Chiarella learned of corporate takeover bids through his employment with a financial printing company.⁶⁴ Despite the acquiring company's efforts to disguise the confidential information in documents sent to the printer, Chiarella deduced the identities

⁵⁶ See *Texas Gulf Sulphur Co.*, 401 F.2d at 850 n.12.

⁵⁷ See *id.* at 848.

⁵⁸ See *United States v. Chiarella*, 445 U.S. 222, 222 (1980). The Court rejected the court of appeals' reasoning, which emphasized the need for equal access to information and the unfairness to less informed traders. See *id.* at 231-32; see also O'KELLY & THOMPSON, *supra* note 44, at 1233 (noting that *Chiarella* sent insider trading jurisprudence in different direction).

⁵⁹ See *Chiarella*, 445 U.S. at 230 (recognizing that prior administrative and judicial opinions establish that silence may be fraudulent despite absence of specific statutory language).

⁶⁰ See *id.* at 230, 235 (holding that duty to disclose does not arise from mere possession of inside information; rather duty to disclose arises from relationship of trust and confidence between parties to transaction).

⁶¹ See *id.* at 230.

⁶² See *id.* (noting that corporate insiders have obligation to put shareholders' welfare before their personal interests). A relationship of trust and confidence also exists between certified public accountants issuing an annual report and that company's shareholders. See *Issen v. GSC Enters.*, 538 F. Supp. 745, 751 (N.D. Ill. 1982). But see *Gold v. DCL, Inc.*, 399 F. Supp. 1123, 1128 (S.D. N.Y. 1973) (holding that mere possession of material facts does not create liability when auditor does not issue certified opinion). Bank officers may also be liable to investors if they give investment advice, recommend investments, and bring investors and borrowers together. See *Warde & Sons v. Colorado Nat'l Bank*, 502 F. Supp. 461, 463-64 (D. Colo. 1980) (holding situation created question of fact for jury to decide if relationship of trust and confidence existed). The relationship is insufficient for imposing liability upon an acquiring corporation one year after the takeover when the target corporation issued the allegedly fraudulent securities. See *Resource Investors Group v. Natural Resource Inv. Corp.*, 457 F. Supp. 194, 197 (E.D. Mich. 1978).

⁶³ See *Chiarella*, 445 U.S. at 231-33 (noting that Chiarella was not corporate insider). Chiarella was not an agent or fiduciary of the other traders, but a complete stranger. See *id.*

⁶⁴ See *id.* at 224. Chiarella's position as a printer employed by a financial printing company gave him access to several announcements. See *id.*

of multiple target companies and purchased their stock before the information became public.⁶⁵ Chiarella had no relationship with the target companies or their shareholders;⁶⁶ he was not an insider of any company in which he purchased stock.⁶⁷ Therefore, the Court held that he had no duty to disclose his information advantage.⁶⁸ Consequently, the focus on a relationship between the parties to a transaction and a duty to disclose became the thrust of the classical theory of insider trading.⁶⁹ In essence, the classical theory prohibits corporate insiders from buying or selling their corporation's securities without first publicly disclosing important corporate information because shareholders trust insiders to act in their interest.⁷⁰

2. Development of the Misappropriation Theory of Insider Trading

Perhaps anticipating the Supreme Court's unwillingness to apply the classical theory in *Chiarella*, the government proposed that the Court apply an alternative theory: misappropriation.⁷¹ The government argued that the Court should uphold Chiarella's conviction because he breached a duty owed to the acquiring corporations. Chiarella misappropriated their confidential information contained in documents sent to the printing company and then used it in trading.⁷² This breach of duty, the government argued, was fraud under section 10(b).⁷³ The majority, however, declined to validate this theory because the government never presented it to the jury.⁷⁴ Nevertheless, Chief Justice Burger, in his dissenting opinion, agreed that the misappropriation theory was valid under

⁶⁵ *See id.* The documents were delivered to the printer in advance of the takeover bid and the true identities were concealed from the printing company until the night before final printing. *See id.*

⁶⁶ *See id.* at 232-33 (noting that Chiarella was complete stranger to sellers he dealt with).

⁶⁷ *See id.* at 231.

⁶⁸ *See id.* at 230-31; *see also supra* notes 64-65 and accompanying text (noting that insider obtained information advantage not by relationship with shareholders, but rather by access to confidential documents provided by acquiring company).

⁶⁹ *See* *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997) (noting that classical theory rests on corporate insider's relationship of trust and confidence with shareholders (citing *Chiarella*, 445 U.S. at 228)).

⁷⁰ *See id.* (describing insider's relationship of trust and confidence with shareholders).

⁷¹ *See Chiarella*, 445 U.S. at 235 (noting government's proffered alternative theory to support Chiarella's conviction).

⁷² *See id.* at 235-36.

⁷³ *See id.*

⁷⁴ *See id.* at 236-37.

10(b).⁷⁵

The Chief Justice found a plain violation of 10(b) because Chiarella misappropriated valuable nonpublic information to use in a securities transaction.⁷⁶ Citing *Cady Roberts*, Burger reasoned that the acquiring company entrusted Chiarella with confidential information and that he breached this trust.⁷⁷ Furthermore, the information gave him an undue trading advantage that he exploited at others' expense by purchasing securities.⁷⁸ Finally, Burger emphasized that *Texas Gulf Sulphur's* "disclose or refrain" rule should apply to misappropriators as well.⁷⁹

Although the majority in *Chiarella* refused to decide the validity of the misappropriation theory, lower courts have since upheld the theory.⁸⁰ However, these courts have not strictly followed Burger's reasoning.⁸¹ Whereas Burger emphasized the misappropriator's unfair trading advantage, lower courts focused more closely on the deception of the person, or source, that entrusted the information to the confidant-turned-trader.⁸²

The SEC successfully used the misappropriation theory in administrative adjudications to take action against traders whose conduct did not fall within the classical insider trading framework.⁸³ In fact, the SEC has relied on this theory for as much

⁷⁵ See *id.* at 240 (arguing that person who misappropriates information should disclose that information or refrain from trading).

⁷⁶ See *id.* at 245.

⁷⁷ See *id.* at 244.

⁷⁸ See *id.* at 245.

⁷⁹ See *id.* at 240 (arguing for disclose or refrain rule).

⁸⁰ The Second, Seventh, and Ninth Circuits adopted the misappropriation theory, while the Fourth and Eighth rejected it. See, e.g., *United States v. O'Hagan*, 92 F.3d 612, 621-22 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997); *SEC v. Maio*, 51 F.3d 623, 631 (7th Cir. 1995); *United States v. Bryan*, 58 F.3d 933, 944 (4th Cir. 1995); *United States v. Chestman*, 947 F.2d 551, 566 (2d Cir. 1991); *SEC v. Clark*, 915 F.2d 439, 453 (9th Cir. 1990). The first case validating the misappropriation theory was *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983).

⁸¹ See *Newman*, 664 F.2d at 17-18 (discussing misappropriation by employees of securities firm as harmful to employer and its clients and rejecting arguments that defrauded plaintiff must be purchaser or seller); see also Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 115 (1984) (noting that lower courts have not embraced Burger's version of misappropriation theory). Aldave criticizes the *Newman* Court for failing to explain adequately the reasons why misappropriation is wrongful. See *id.* at 118. She argues that the conduct is wrongful because the person that entrusted the misappropriator with information was deceived in a fashion similar to embezzlement. See *id.* at 118-19.

⁸² See *supra* note 81 and accompanying text (discussing misappropriation theory's focus of harm upon the information source).

⁸³ See Felsenthal, *supra* note 5, at C1 (noting that since early 1980s government has nabbed stock traders that obtain nonpublic information but that do not qualify as company

as forty-five percent of its insider trading cases over the last several years.⁸⁴ Only recently, when circuit courts took conflicting positions on the theory,⁸⁵ did the Court revisit the issue in *O'Hagan*.⁸⁶ Although the *O'Hagan* Court adopts the misappropriation theory, the Court explicitly provides a defense which fails to support the public policies behind the securities laws.

II. UNITED STATES V. O'HAGAN

A. Facts

James O'Hagan was an attorney with Dorsey & Whitney, a Minneapolis law firm.⁸⁷ In 1988, Grand Metropolitan PLC ("Grand Met") retained Dorsey & Whitney as its local counsel for a proposed tender offer for the Pillsbury Company.⁸⁸ Although O'Hagan did not work on the Grand Met transaction, he learned of the proposed tender offer from a conversation with another Dorsey & Whitney attorney.⁸⁹ O'Hagan subsequently purchased Pillsbury stock and call option contracts.⁹⁰ When Grand Met publicly announced its tender offer, Pillsbury's stock price rose from thirty-nine dollars per share to nearly sixty dollars per share.⁹¹ The value of O'Hagan's purchases yielded more than \$4.3 million in profits, which he then used to conceal his previous embezzlement of client trust funds.⁹² A jury, applying the misappropriation theory, convicted O'Hagan of, among other things,⁹³ seventeen counts

insiders).

⁸⁴ See *id.*

⁸⁵ The Second, Seventh, and Ninth Circuits adopted the misappropriation theory, while the Fourth and Eighth rejected it. See, e.g., *United States v. O'Hagan*, 92 F.3d 612, 621-22 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997); *SEC v. Maio*, 51 F.3d 623, 631 (7th Cir. 1995); *United States v. Bryan*, 58 F.3d 933, 944 (4th Cir. 1995); *United States v. Chestman*, 947 F.2d 551, 566 (2d Cir. 1991); *SEC v. Clark*, 915 F.2d 439, 453 (9th Cir. 1990).

⁸⁶ 521 U.S. 642 (1997).

⁸⁷ *O'Hagan* involves the validity of the misappropriation theory, the applicability of mail fraud statutes, money laundering, and the rulemaking authority of the SEC under section 14(e) of the 1934 Act. See *id.* at 649. This Note, however, discusses only those parts of *O'Hagan* relating to the misappropriation theory, section 10(b), and Rule 10b-5.

⁸⁸ See *O'Hagan*, 92 F.3d at 614.

⁸⁹ See *O'Hagan*, 521 U.S. at 648 n.1.

⁹⁰ See *id.* at 647-48.

⁹¹ See *id.* at 648.

⁹² See *id.*

⁹³ O'Hagan was also convicted of 20 counts of mail fraud, 17 counts of fraudulent trading in connection with a tender offer in violation of section 14(e) of the 1934 Act, and 3 counts of violating federal money laundering statutes. See *id.* at 648-49. As noted in the Introduction, this Note limits the discussion to section 10(b) and Rule 10b-5 violations.

of securities fraud in violation of section 10(b) and Rule 10b-5.⁹⁴

B. *The Eighth Circuit Reverses O'Hagan's Conviction*

The Eighth Circuit overturned the lower court and held that the misappropriation theory was an invalid basis for section 10(b) liability for two reasons.⁹⁵ First, the court reasoned that the misappropriation theory construes Rule 10b-5 too broadly because it dispenses with the deception requirement.⁹⁶ A conviction under section 10(b) requires deception, which is a material misrepresentation or nondisclosure.⁹⁷ Therefore, the court held that Rule 10b-5 cannot support liability for a mere breach of fiduciary duty unless accompanied by misrepresentation or nondisclosure.⁹⁸ Because the court found that the misappropriation theory could support a conviction for a mere fiduciary breach, the court ruled that the theory was invalid.⁹⁹

The court's second reason for invalidating the misappropriation theory involved a causation analysis.¹⁰⁰ Section 10(b) prohibits deception "in connection with the purchase or sale of any security."¹⁰¹ The court found that the misappropriation theory transformed section 10(b) into a fraud-on-the-source theory.¹⁰² The court reasoned that the "in connection with" requirement of section 10(b) limits the types of actionable deception. Specifically, section 10(b) prohibits only deception that is practiced "upon" a purchaser or seller.¹⁰³ The misappropriation theory, however, views the fiduciary breach and the purchase or sale as two wholly

⁹⁴ See *id.* at 648. The state convicted O'Hagan of theft and disbarred him from the practice of law. See *id.* at 648 n.2.

⁹⁵ See *United States v. O'Hagan*, 92 F.3d 612, 622 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997).

⁹⁶ See *O'Hagan*, 92 F.3d at 617-18.

⁹⁷ See *id.* at 618.

⁹⁸ See *id.*

⁹⁹ See *id.* at 616.

¹⁰⁰ See *id.* at 617 (noting failure of theory requiring deception to be in connection with purchase or sale).

¹⁰¹ 15 U.S.C. § 78j (1994).

¹⁰² See *O'Hagan*, 92 F.3d at 619; see also, e.g., *United States v. Bryan*, 58 F.3d 933, 950 (4th Cir. 1995) (noting that *Chiarella* Court rejected fraud-on-the-market, in which market traders have unequal information, and that fraud-on-the-source theory pursues same improper goal).

¹⁰³ See *O'Hagan*, 92 F.3d at 619 (arguing that deception must be practiced upon parties to securities transaction or other market participants (citing *Bryan*, 58 F.3d at 950)).

unrelated inquiries.¹⁰⁴ For these reasons, the court found the misappropriation theory invalid despite contrary conclusions from four other circuit courts.¹⁰⁵ This circuit split prompted the Supreme Court to review the validity of the misappropriation theory.¹⁰⁶

C. *The Supreme Court Upholds Misappropriation as a Valid Section 10(b) Theory*

The United States Supreme Court reversed the Eighth Circuit and upheld O'Hagan's conviction under section 10(b).¹⁰⁷ The Court held that a person who trades securities using misappropriated confidential information is guilty of violating section 10(b) and Rule 10b-5.¹⁰⁸ Looking first to the language of the statute, the Court found that section 10(b) proscribes the use of a deceptive device in connection with the purchase or sale of securities.¹⁰⁹ After reviewing the classical insider trading framework, the Court noted that the government could not prosecute O'Hagan under this framework because he was not an insider of Pillsbury,¹¹⁰ the company whose stock and options he traded.¹¹¹ Conversely, O'Hagan only owed a duty to his law firm, Dorsey & Whitney, and to its client, Grand Met.¹¹² The information about the tender offer was Grand Met's property.¹¹³ Thus, O'Hagan had no relationship with, or duty towards, Pillsbury and its shareholders.¹¹⁴

Turning to the validity of the misappropriation theory, the Court first noted that the language of section 10(b) does not restrict the inquiry to deception of buyers and sellers.¹¹⁵ Rather, the statute prohibits the use of a deceptive device in connection with the pur-

¹⁰⁴ See *id.*

¹⁰⁵ See *id.* at 620; see also, e.g., *United States v. Bryan*, 58 F.3d 933, 944 (4th Cir. 1995); *SEC v. Maio*, 51 F.3d 623, 632 (7th Cir. 1995); *United States v. Chestman*, 947 F.2d 551, 564 (2d Cir. 1991); *SEC v. Clark*, 915 F.2d 439, 453 (9th Cir. 1990).

¹⁰⁶ See *United States v. O'Hagan*, 521 U.S. 642, 649 (1997).

¹⁰⁷ See *id.* at 650.

¹⁰⁸ See *id.* at 650, 658-66.

¹⁰⁹ See *id.* at 650-51; see also 15 U.S.C. § 78j(b) (1994).

¹¹⁰ See *O'Hagan*, 521 U.S. at 653 n.5.

¹¹¹ See *id.*

¹¹² See *id.* (noting O'Hagan's intimate relationship with Dorsey & Whitney and law firm's relationship to its client).

¹¹³ See *id.* at 654 (describing confidential information as property of corporation and corporation's right to exclusive use).

¹¹⁴ See *id.* at 653 n.5 (noting O'Hagan's status as outsider to Pillsbury).

¹¹⁵ See *id.* at 651.

chase or sale of securities.¹¹⁶ Second, the Court explained that a principal is entitled to the exclusive use of its confidential information because that information is the principal's property.¹¹⁷ The principal's agent defrauds him when, in breach of a duty of loyalty and confidentiality, the agent uses that information without permission.¹¹⁸ According to the Court, this fraud satisfies section 10(b)'s deception requirement.¹¹⁹

Finally, the agent satisfies the "in connection with" requirement when he uses the principal's information to purchase or sell securities.¹²⁰ Ordinarily, this type of information is valuable to the agent by providing no-risk profits when buying or selling securities.¹²¹ However, should the agent find a use for the information other than the purchase or sale of securities, the agent would not violate section 10(b).¹²² Consequently, the Court held that the misappropriation theory fully satisfies section 10(b)'s deception and "in connection with" requirements.¹²³

Considering various securities law policies, the Court found that the misappropriation theory protects the market's integrity by proscribing trading that improperly capitalizes on material nonpublic information.¹²⁴ Notably, the Court recognized that although the trader deceives the source, the trader simultaneously harms the investing public.¹²⁵ Unfortunately, in an attempt to explain the misappropriation theory, the Court further stated that full disclosure by the fiduciary to the source of the information forecloses liability under the misappropriation theory.¹²⁶

¹¹⁶ *See id.*

¹¹⁷ *See id.* at 654 (noting that confidential information qualifies as property belonging to corporation).

¹¹⁸ *See id.* at 652.

¹¹⁹ *See id.* at 654 (analogizing fiduciary breach to embezzlement).

¹²⁰ *See id.* at 656-57.

¹²¹ *See id.* at 656.

¹²² *See id.*

¹²³ *See id.* at 665-66.

¹²⁴ *See id.* at 653 (noting theory protects against abuses by outsiders that gain access to information that will affect security's price).

¹²⁵ *See id.* at 656 (citing Aldave, *supra* note 81, at 120); *see also id.* at 659 n.9 (finding that even when agent discloses trading plans to principal, conduct may affect market in same manner).

¹²⁶ *See id.* at 655. Although full disclosure negates the deception requirement, the Court noted that the trader might still be liable under state law for a breach of loyalty. *See id.*

III. ANALYSIS OF *O'HAGAN* AND THE MISAPPROPRIATION THEORY

Although the Court correctly upheld O'Hagan's conviction, in its attempt to reach the desired result, the Court created an insider trading defense wholly inconsistent with securities law policies. This Part proposes an alternative theory that would uphold O'Hagan's conviction and eliminate the undesirable defense. Specifically, the proffered theory recognizes that confidential information is the property of investors and insider trading defrauds them. Finally, this Part provides two factual scenarios to illustrate how the suggested theory would work.

A. *Misappropriation: An Improper Focus on Deception of the Source*

Public policy strongly supports O'Hagan's conviction.¹²⁷ Section two of the 1934 Act specifically mentions the policy of fairness when articulating the Act's necessity.¹²⁸ Furthermore, section 10(b) specifies that the SEC may proscribe rules necessary "for the protection of investors."¹²⁹ This language leaves no doubt about the purpose for which these laws exist. Even the Eighth Circuit, while overturning O'Hagan's conviction, cautioned that it did not condone his conduct.¹³⁰ It found O'Hagan's conduct both unethical and immoral and applauded his disbarment.¹³¹ If the Supreme Court had allowed O'Hagan's actions to continue, investors would surely have less confidence in the securities markets.¹³² Without investor confidence, a borrower's cost of capital rises, and overall market efficiency suffers.¹³³ For all these reasons, the Court properly upheld O'Hagan's conviction.

Notwithstanding the correct result in *O'Hagan*, the misappropriation theory's focus as a fraud on the source of the nonpublic information fails to recognize for whom section 10(b) exists. Spe-

¹²⁷ See *id.* at 657 (noting policies of fair and honest markets); see also *SEC v. Materia*, 745 F.2d 197, 203-04 (2d Cir. 1984) (arguing that legislative purpose of 1934 Act is to ensure open and honest markets which precludes no-risk profits through fraudulent activity).

¹²⁸ See 15 U.S.C. § 78b (1994) (stating that regulation is necessary for maintenance of fair and honest markets).

¹²⁹ *Id.* § 78j.

¹³⁰ See *United States v. O'Hagan*, 92 F.3d 612, 628 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997).

¹³¹ See *O'Hagan*, 92 F.3d at 628.

¹³² See *O'Hagan*, 521 U.S. at 658 (arguing that investors would hesitate to invest in markets where trading on misappropriated information was lawful).

¹³³ See *supra* notes 4, 6-7 and accompanying text (defining market efficiency and congressional action on insider trading).

cifically, section 10(b) exists for the protection of investors.¹³⁴ By requiring insider traders to disclose their trading plan only to the source, and not to investors, the Court fashions a defense which leaves investors subject to the evils of insider trading.

The *O'Hagan* Court held that disclosing an insider's trading plan to the source forecloses liability under the misappropriation theory because disclosure negates deception.¹³⁵ But as the dissent points out, in lieu of a commission, salary or other form of payment, a company may grant permission to an insider to trade securities and profit from information that is not yet public.¹³⁶ With such authorization, the agent would not violate section 10(b),¹³⁷ but still injure unsuspecting investors.¹³⁸ This type of insider trading frustrates securities law policies.¹³⁹

As the misappropriation theory now stands, it fails to support securities law policies. The theory provides its own defense: disclosing your actions to the source forecloses a 10(b) violation.¹⁴⁰ Disclosure to the source, however, does not alleviate the resultant harm to market participants when a trader purchases securities with material nonpublic information.¹⁴¹ An alternative approach holds *O'Hagan* liable, negates this defense, and better protects securities law policies.

¹³⁴ See 15 U.S.C. § 78j (allowing SEC to promulgate rules and regulations in public interest or for protection of investors).

¹³⁵ See *O'Hagan*, 521 U.S. at 655.

¹³⁶ See *id.* at 689 (noting that if authorization were given as bonus there is no section 10(b) violation). For example, Grand Met might have authorized *O'Hagan* to buy shares of Pillsbury in exchange for legal work on the takeover. See *id.* Shareholders of Pillsbury are harmed in this transaction. See *id.* And although, in this case, the information actually belongs to Grand Met, Grand Met is prohibited from using the information to harm Pillsbury shareholders. See generally 17 C.F.R. § 240.13d-1 to -7 (1997) (preventing acquiring company from having more than five percent of target before making its actions public).

¹³⁷ See *O'Hagan*, 521 U.S. at 655 (noting that disclosure to source forecloses liability).

¹³⁸ See *Aldave*, *supra* note 81, at 120-21 (discussing injuries to market participants opposing people trading on inside information).

¹³⁹ See *supra* notes 127-33 and accompanying text (describing policies against no-risk profits at other's expense, policies for fair and open markets for investor protection, and policies for market efficiency).

¹⁴⁰ See *O'Hagan*, 521 U.S. at 655 (noting that full disclosure forecloses liability under misappropriation theory).

¹⁴¹ See *supra* note 12 and accompanying text (describing opposing traders as automatic losers).

B. Equal Access: Focusing on the Investor

The proper line for the Court to draw is one that protects and encourages the legitimate gathering of information.¹⁴² The Court should prohibit the trading of securities based on an information advantage not attained through lawful effort, industrious diligence, or superior analytical ability.¹⁴³ Although parity of information is unattainable in a complex, anonymous market,¹⁴⁴ the Court should strive to provide each market participant equal access to information.¹⁴⁵ In fact, the securities laws can easily be understood as Congress's attempt to achieve equal access.¹⁴⁶ The Court should explicitly recognize that the purpose of the securities laws is to provide equal access and that investors expect as much.¹⁴⁷ The Court should equate this expectation with a property right in the information.¹⁴⁸

Critics of the equal access theory may argue that the theory creates a general duty among strangers to forego transactions unless all traders possess identical information. Critics, furthermore, may correctly argue that the *O'Hagan* Court has specifically rejected such a duty.¹⁴⁹ In *O'Hagan*, the Court reiterated *Chiarella's* mantra that there is "no general duty between all participants in market transactions to forego actions based on material nonpublic information."¹⁵⁰ However, the *Chiarella* Court characterized this formu-

¹⁴² See *Chiarella v. United States*, 445 U.S. 222, 239-40 (1980) (Burger, C.J., dissenting). Chief Justice Burger noted that, generally, parties in an arm's length transaction are not obliged to disclose information. See *id.* This provides an incentive for hard work and careful analysis. See *id.* at 240. However, he argued, the general rule should not apply when information is obtained unlawfully. See *id.*

¹⁴³ See Brudney, *supra* note 4, at 341 (noting that outsiders require return to compensate for effort, time, and money for research and training in securities analysis).

¹⁴⁴ See *id.* at 339-43 (explaining difficulties of equality of information rule).

¹⁴⁵ See *Chiarella*, 445 U.S. at 250 (Blackmun, J., dissenting) (arguing that Rule 10b-5 is based on policy of relatively equal access to material information).

¹⁴⁶ See Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 359 (1988) (noting that public reporting system creates expectation of generally accessible material information). In fact, courts have striven to find relationships of trust and confidence to ensure conditions of equal access. See *id.* at 361. However, equal access may also be seen as transferring wealth from informed traders to uninformed traders, and market professionals are likely to be the greatest beneficiaries of equal access rules. See *id.* at 360.

¹⁴⁷ See Bell, *supra* note 16, at 541 nn.35-36 (noting that goal of investor protection is accomplished through mandatory disclosure of relevant information).

¹⁴⁸ See *United States v. O'Hagan*, 521 U.S. 642, 654 (1997) (noting that company's confidential information is property). Because the information is property, the shareholders should own the information. See *id.*

¹⁴⁹ See *id.* at 660-61.

¹⁵⁰ *Id.* (citing *Chiarella v. United States*, 445 U.S. 222, 233 (1980)).

lation as a "parity-of-information rule" which neither Congress nor the SEC has ever adopted.¹⁵¹ The equal access theory does not require parity of information, only parity of access to information.¹⁵² Investors will be precluded from invoking section 10(b) under the equal access theory when they claim injury, yet fail to expend the required time, effort, and skill to discover and analyze information that is publicly available.¹⁵³

For a specific example of a group of investors who would have a property right in confidential information under the equal access theory, consider the following discussion. Following the *O'Hagan* Court's reasoning, a corporation owns its confidential information.¹⁵⁴ Shareholders own the corporation.¹⁵⁵ Therefore, shareholders own the confidential information. These shareholders, thus, have the exclusive right to use confidential information.¹⁵⁶ Insiders should keep information confidential only when it benefits the shareholders, such as when the corporation's strategy would be replicated by a competitor if it were disclosed.¹⁵⁷ However, when insiders use that information to profit at the expense of shareholders, the shareholders are defrauded.¹⁵⁸ The deception occurs because use of the confidential information violates the shareholders' expectations and property rights.¹⁵⁹ Section 10(b)

¹⁵¹ See *Chiarella v. United States*, 445 U.S. 222, 233 (1980) (noting that neither Congress nor Commission ever adopted "parity-of-information" rule).

¹⁵² See *supra* note 146 and accompanying text (noting that equal access is unattainable in complex, anonymous market).

¹⁵³ See *supra* notes 144-45 and accompanying text (noting that proper line for Court to draw is one that protects and encourages legitimate gathering of information while prohibiting pure information advantages that cannot be overcome regardless of lawful effort, industrious diligence, or superior analytical ability).

¹⁵⁴ See *O'Hagan*, 521 U.S. at 654 (recognizing confidential information as property of corporation).

¹⁵⁵ See, e.g., *Nejmanowski v. Nejmanowski*, 841 F. Supp. 864, 866 (C.D. Ill. 1994) (noting that shareholders are ultimate, although passive, owners of corporations).

¹⁵⁶ See BLACK'S LAW DICTIONARY 1216 (6th ed. 1990) (defining "property" as aggregate of rights, including exclusive right to use). But see *O'Hagan*, 521 U.S. at 654 (describing confidential information as belonging to corporation that has exclusive right to use).

¹⁵⁷ See BLACK'S LAW DICTIONARY 1216 (6th ed. 1990) (defining "property" as including unrestricted right to use or dispose). For an example of an agreement attempting to define when a trustee may use confidential information, see *Klamberg v. Roth*, 473 F. Supp. 544, 555 (S.D.N.Y. 1979). The plaintiff alleged that the defendants owed an undivided loyalty to shareholders that included the obligation to not disclose any inside or confidential information that would adversely affect the assets or constitute a violation of the insider disclosure requirements of the Securities Acts. See *id.*

¹⁵⁸ See *supra* notes 120-21 and accompanying text (noting that agent defrauds principal when using information without permission).

¹⁵⁹ See *supra* notes 147-48 and accompanying text (arguing that investors expect access to information and their expectation should be equated with property rights).

should cover such deception.

The duty to disclose material nonpublic information or otherwise to refrain from trading should apply to all market participants. Congress recognized the importance of having necessary information publicly available to permit investors to properly value investments and, thus, receive adequate protection from the securities laws.¹⁶⁰ Only when the securities laws assure equal access to information will the securities markets be truly fair, efficient, and competitive.¹⁶¹

C. *Application of the Equal Access Theory*

Under the equal access theory, a market analyst can lawfully earn superior returns if he can digest and analyze publicly available information more accurately and efficiently than other investors.¹⁶² However, unless a company releases the information in a press conference, or a news reporter publishes the information, or the information is otherwise generally available to all traders, the analyst with nonpublic information must refrain from trading.

Suppose, for example, that a company publicly announces plans to raise money in the future. An analyst might determine that companies in that industry spend little money on research and development. The analyst might also surmise that the industry is overcrowded and no reasonable management team would expand unilaterally. From these facts, the analyst might deduce that the company is planning to raise money for the purposes of acquiring a competitor. The analyst might further deduce which competitors are likely to become targets based on the potential for antitrust approval.¹⁶³ If the analyst's theory proves correct, investing accordingly will return a sizable profit.¹⁶⁴ Under this scenario, the ana-

¹⁶⁰ See *supra* notes 23-26 and accompanying text (describing 1933 Act's purposes as protecting investors through dissemination of relevant information).

¹⁶¹ See Goelzer, *supra* note 42, at 2 (noting that efficient and fair markets depend on investor confidence which is threatened by insider trading).

¹⁶² See Brudney, *supra* note 4, at 360 (arguing that systematic inequality may result from disparities in power, wealth, diligence, or intelligence).

¹⁶³ See *Dr Pepper/Seven-Up Cos. v. FTC*, 991 F.2d 859, 862 (D.C. Cir. 1993) (describing FTC's prior approval procedures for acquisitions which, in this case, took eight months to deny application).

¹⁶⁴ If the analyst accurately discovers the identity of the acquisition target she will discover information that is not publicly available. The strong-form view of market efficiency states that market prices reflect all information, publicly available or not. See STEPHEN A. ROSS ET AL., *CORPORATE FINANCE* 340 (4th ed. 1996). If the market is strong-form efficient,

lyst's superior ability to synthesize all relevant information produces high investment returns. The analyst has also taken the risk that he may be wrong. Although his superior skill gives him an advantage over others, he has not deceived anyone within the meaning of section 10(b).¹⁶⁵ This type of activity is supported by public policies favoring incentives for individual diligence, skill, and effort.¹⁶⁶

Consider the following as a scenario which violates the equal access rule. Suppose a consultant performs a comprehensive study of potential suppliers for his client. The consultant will recommend selection of a single supplier of components for a product his client is currently developing. The selected supplier will gain a long-term, highly profitable contract. The value of this contract will inevitably increase the price of the supplier's stock as soon as the selection is publicly announced.¹⁶⁷ If the consultant were to purchase the supplier's securities prior to the public disclosure of the client's selection, he would be trading on information that no other trader could possibly obtain. Not privy to this nonpublic information, investors from whom the consultant would purchase the supplier's securities would sell them at a price below their actual value. Such investors undervalue the supplier's stock because they do not account for the value of the nonpublic information.¹⁶⁸ The investors' right to value the security from the same perspective as the consultant and the unfairness of the consultant's advantage are two reasons to prohibit the consultant from purchasing prior to public disclosure.¹⁶⁹

the implication is that the analyst will not be able to earn superior returns from her discovery. *See id.* at 335. However, academic evidence does not support strong-form efficiency and, thus, the analyst in this hypothetical would earn superior returns. *See id.* at 352-53 (citing J. Jaffe, *Special Information and Insider Trading*, J. OF BUS. (July 1974)).

¹⁶⁵ *See* 15 U.S.C. § 78j (1994). In this case, there is no deception because the information is freely accessible to shareholders. *See* 2 HAZEN, *supra* note 1, § 13.2.

¹⁶⁶ *See* Chiarella v. United States, 445 U.S. 222, 240 (1980) (Burger, C.J., dissenting) (noting that rule allowing nondisclosure of information obtained by individual effort provides incentives); *see also* Brudney, *supra* note 4, at 341 (noting that effort expended for discovery of information is beneficial to market efficiency and that financial returns must be available to those performing such function).

¹⁶⁷ *See, e.g.*, Terzah Ewing & Carlos Tejada, *Oil-Service Firms See Stocks Climb on Strong Demand*, WALL ST. J., Oct. 10, 1997, available in 1997 WL 14169533 (reporting 10.4% rise in stock price for one company upon public announcement of record-setting contract price for offshore rig lease).

¹⁶⁸ *See* Brudney, *supra* note 4, at 346 (analogizing to trust beneficiaries and recognizing that prohibition on trustee not to deal with beneficiaries in trust assets is based partly on beneficiaries' expectations).

¹⁶⁹ *See generally* COX ET AL., *supra* note 19, at 823-24 (discussing benefits of insider trading

Under the present version of the misappropriation theory, however, the consultant could only be liable for insider trading if he either failed to obtain his client's authorization to trade or failed to disclose his plan to his client.¹⁷⁰ But the client could give him this authorization as compensation, thus allowing the client to retain the services of the consultant without actually paying him. Additionally, the consultant could disclose his trading plan to his client and immediately purchase the securities before the client makes a public announcement.¹⁷¹ In either scenario, the consultant does not deceive his client and, thus, escapes liability under the misappropriation theory. The harm to investors, however, remains.¹⁷²

Under the equal access theory the consultant is using material nonpublic information that will affect the price of the supplier's securities. Although the consultant may be seen as the creator of this information for his client, and it is the client who has a property right in the information, allowing the consultant to profit at the expense of the supplier's shareholders is unfair and would be prohibited under the equal access theory. The consultant has not undertaken an activity to merely discover and analyze public data. He has created confidential information that materially affects the supplier's stock value. These shareholders expect equal access to material information.¹⁷³ In this scenario, there are competing property rights: the client's right to use confidential information created for its use, and the supplier shareholders' right of access to information to properly value their investment.¹⁷⁴ When the nature of the information is such that it will affect the security's price, and is not merely information derived from analyzing publicly available information,¹⁷⁵ public policies favor disclosure.¹⁷⁶ In this situation,

regulation in response to criticism).

¹⁷⁰ See *United States v. O'Hagan*, 521 U.S. 642, 655 (1997) (noting that full disclosure to information source negates deception requirement, thus foreclosing liability under misappropriation theory).

¹⁷¹ See *supra* notes 46-47 and accompanying text (noting that broker was able to trade securities during recess of meeting before the corporation could publicly announce dividend cut).

¹⁷² See *supra* notes 125-26 and accompanying text (noting that disclosure negates deception requirement, yet investors are still harmed by trader's conduct).

¹⁷³ See *supra* notes 147-48 and accompanying text (arguing that investors expect access to information and their expectation should be equated with property rights).

¹⁷⁴ See *supra* note 156 and accompanying text (describing property rights); see also *supra* notes 147-48 and accompanying text (arguing that investors expect access to information and their expectation should be equated with property rights).

¹⁷⁵ The consultant's recommendation will affect the security's price even if she analyzed only publicly available information in selecting a supplier. See *supra* note 167 and accompa-

the equal access theory would give priority to the right of the supplier's shareholder. The consultant should not gain risk-free profits at the expense of shareholders.¹⁷⁷ This is deceptive to shareholders and the consultant would violate section 10(b) under the equal access theory.

CONCLUSION

The misappropriation theory, as the Supreme Court describes it, fails to protect investors from pure information advantages that cannot be overcome with skill or diligence. The resulting harm is perpetrated upon market participants as well as the source of the stolen information. The Court creates a misappropriation defense which fails to uphold securities law policies. The defense fails to ensure equal access to information and, therefore, should not be recognized when unequal access to material information results. Equal access is a better theory because it recognizes that access to information is essential to the market. The equal access theory comports with the securities law policies of protecting investors and ensuring honest and fair securities markets, policies upon which the *O'Hagan* Court's analysis depended.

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nying text (noting that price movement resulted from announcement of awarding contract). Although a similar effect may occur when a security analyst recommends buying a particular company's stock, the analyst's effort should be encouraged and protected because it results in a more efficient allocation of capital. See Brudney, *supra* note 4, at 341 (noting efficiencies from discovery of information). However, when the consultant trades using the confidential information, the result is an undesirable transfer of wealth from market participants that were denied the ability to compete on equal terms with the consultant. See *id.*

¹⁷⁶ Compare *supra* notes 25-26 and accompanying text (describing purposes of 1933 Act and methods of achieving disclosure), with *supra* note 142 and accompanying text (describing nondisclosure as incentive for hard work and careful analysis of publicly available information).

¹⁷⁷ See *United States v. Chiarella*, 445 U.S. 222, 241 (1980) (Burger, C.J., dissenting).