

CIVIL LIABILITY UNDER EXCHANGE ACT RULE 10B-5 FOR MISAPPROPRIATORS OF NONPUBLIC INFORMATION: AN ARGUMENT FOR CONSISTENCY

The Securities Exchange Act of 1934 is the cornerstone of the federal government's efforts to regulate the securities markets; Rule 10b-5 lies at the heart of the federal regulatory framework.¹ The broad language of Rule 10b-5 and the underlying statute are designed to catch a wide variety of fraudulent schemes that wreak havoc on securities markets.² The Securities and Exchange Commission ("SEC") enforces these provisions.³

Traditionally, the SEC has used Rule 10b-5 to combat insider trading.⁴ Typically, an insider is a corporate official who obtains material, nonpublic information about the corporation in the course of employment.⁵ An insider obtains confidential information about the corporation as a result of the insider's position of trust within the corporation.⁶ This gives rise to a fiduciary duty to the corporation's shareholders under state law, apart from the duties imposed by federal securities law.⁷ Rule 10b-5 prohibits an insider from trading in the corporation's securities based on material, nonpublic information because such trading is a fraudulent breach of the insider's duty to the corporation's shareholders.⁸

The misappropriation theory expands Rule 10b-5 to prohibit conduct that does not fall within the traditional conception of insider trading.⁹ The misappropriation theory applies when a person other

¹ See 17 C.F.R. § 240.10b-5 (1997); *Chiarella v. United States*, 445 U.S. 222, 248 (1980) (Blackmun, J., dissenting) ("[T]heir purpose is to ensure the fair and honest functioning of . . . markets where common-law protections have proved inadequate."). The Securities Exchange Act is codified at 15 U.S.C. § 78a *et seq.* (1994).

² See 15 U.S.C. § 78j(b) (1994); *Chiarella*, 445 U.S. at 246 (Blackmun, J., dissenting); 17 C.F.R. § 240.10b-5 (1997).

³ See 15 U.S.C. § 78u(a) (1994).

⁴ See, e.g., *In re Cadby, Roberts & Co.*, 407 S.E.C. 907, 912 (1961).

⁵ See *United States v. O'Hagan*, 521 U.S. 642, 651-53 (1997) (differentiating between "classical" insider trading and misappropriation theory).

⁶ See *id.* at 652.

⁷ See *id.*

⁸ See *id.*

⁹ See *id.* at 652-53.

than a corporate insider obtains material, nonpublic information about a corporation from a source to which that person owes a fiduciary duty.¹⁰ Under the theory, that person takes the nonpublic information and "misappropriates" it for his or her own use by engaging in a securities transaction.¹¹ Thus, like a traditional insider, the misappropriator's actions produce unfair, risk-free profits and thereby cause the harms that securities laws aim to prevent.¹²

Since its inception, the misappropriation theory has aroused considerable controversy.¹³ In 1997, the United States Supreme Court upheld the validity of the misappropriation theory in the criminal context.¹⁴ The policies driving securities regulation in general, and Rule 10b-5 in particular, militate in favor of the misappropriation theory's adoption in civil cases as well.¹⁵

This Note will first survey the origin and development of the misappropriation theory in the criminal context.¹⁶ Second, this Note will provide a detailed analysis of *United States v. O'Hagan*, the case that settled the controversy surrounding the misappropriation theory.¹⁷ Third, this Note will explore the policy underpinnings of civil suits under Rule 10b-5.¹⁸ Lastly, it will argue that application of the misappropriation theory in civil actions would further these policy goals.¹⁹

I. THE ROAD TO *O'HAGAN*: DEVELOPMENT OF THE MISAPPROPRIATION THEORY IN THE CRIMINAL CONTEXT

Section 10(b) of the Securities Exchange Act of 1934 provides, in relevant part: "It shall be unlawful for any person, directly or indirectly, . . . to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations [that the SEC may provide]."²⁰ Acting pursuant to this grant of rulemaking authority, the SEC promulgated Rule 10b-5.²¹ The Rule provides, in relevant part: "It shall

¹⁰ See *O'Hagan*, 521 U.S. at 652.

¹¹ See *id.*

¹² See *id.* at 659.

¹³ See David Cowan Bayne, S.J., *Insider Theory: The Demise of the Misappropriation Theory—and Thereafter*, 41 ST. LOUIS U. L.J. 625, 637 (1997) (arguing against misappropriation theory's validity); Lawrence A. Rosenbloom, *Is it Inside or Out?—A Proposal to Clarify the Misappropriation Theory of Unlawful Trading*, 18 CARDOZO L. REV. 867 (1997) (arguing in favor of theory's validity).

¹⁴ See *O'Hagan*, 521 U.S. at 650.

¹⁵ See *id.* at 659; *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513-14 (E.D. Pa. 1946).

¹⁶ See *infra* notes 20-111 and accompanying text.

¹⁷ See *infra* notes 112-51 and accompanying text.

¹⁸ See *infra* notes 152-88 and accompanying text.

¹⁹ See *infra* notes 189-231 and accompanying text.

²⁰ 15 U.S.C. § 78j(b) (1994).

²¹ See 17 C.F.R. § 240.10b-5.

be unlawful for any person, directly or indirectly, . . . to employ any device, scheme, or artifice to defraud . . . [or] . . . to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."²² Section 10(b) speaks of "deception," whereas Rule 10b-5 speaks of "fraud."²³ The distinction may seem meaningless, because deception is a necessary element of a fraudulent act.²⁴ Nevertheless, many courts focus on the language of section 10(b), rather than the language of Rule 10b-5.²⁵

In 1980, the United States Supreme Court decided *Chiarella v. United States*, a landmark case construing Rule 10b-5 in the criminal context.²⁶ The Court held that Rule 10b-5 does not create a general duty requiring investors to disclose material, nonpublic information before trading.²⁷ Such a duty, the Court reasoned, arises only where the party in possession of the information has a duty to disclose.²⁸ Because the Court determined that the misappropriation theory was not presented to the jury, it declined to rule on the theory's validity.²⁹

The defendant, Vincent Chiarella, worked for Pandick Press, a financial printer.³⁰ Among other things, Pandick Press printed corporate takeover bids.³¹ The names of the acquiring company and target company were omitted from the documents supplied to the printer.³² The companies' names were supplied at the last minute.³³ In five instances, however, Mr. Chiarella used the other information in the documents to deduce which companies were involved.³⁴ Armed with this information, he purchased stock in the target corporations.³⁵ Mr.

²² *Id.*

²³ See 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

²⁴ See RESTATEMENT (SECOND) OF TORTS § 526 (1966). I have not seen any court or commentator offer an example (actual or hypothetical) where Rule 10b-5 would reach activity that was not "deceptive" within the meaning of section 10(b).

²⁵ See, e.g., *United States v. O'Hagan*, 92 F.3d 612, 615 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997). In this Note, the requirements of fraud and deception are treated interchangeably, unless indicated otherwise.

²⁶ 445 U.S. 222 (1980).

²⁷ See *id.* at 233.

²⁸ See *id.* at 230 ("Such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction.").

²⁹ See *id.* at 236.

³⁰ See *id.* at 224.

³¹ See *Chiarella*, 445 U.S. at 224.

³² See *id.*

³³ See *id.*

³⁴ See *id.*

³⁵ See *id.*

Chiarella later was indicted for violations of Rule 10b-5.³⁶ At trial, the judge instructed the jury to convict Mr. Chiarella if it determined that he traded on material information when "he knew other people trading in the securities market did not have access to the same information."³⁷ The jury returned convictions on all counts, which the Second Circuit ultimately affirmed.³⁸

The Supreme Court overturned Mr. Chiarella's convictions.³⁹ The Court asserted that a person has no duty to refrain from trading in securities solely because that person possesses material, nonpublic information relating to those securities.⁴⁰ The Court noted that there is no legislative history suggesting that Congress intended such a sweeping effect when it enacted section 10(b).⁴¹ The Court also stated that some of the SEC's own regulations recognized that investors had no general duty to disclose material, nonpublic information before trading.⁴²

Having concluded that Rule 10b-5 does not create a general duty to disclose nonpublic information, the Court reasoned that Mr. Chiarella did not violate Rule 10b-5 unless he violated a duty existing apart from federal securities law that made his failure to disclose fraudulent.⁴³ Ostensibly, there were two parties to whom Mr. Chiarella could have owed such a duty: (1) the sellers of the stock; and (2) the acquiring company, from which Mr. Chiarella had converted the nonpublic information.⁴⁴

The Court rejected the notion that Mr. Chiarella owed a duty to the sellers of the stock.⁴⁵ The Court distinguished Mr. Chiarella from a traditional "insider," who obtains material, nonpublic information about a corporation through the insider's position of trust within that corporation.⁴⁶ In such cases, the insider owes a fiduciary duty to the corporation's shareholders.⁴⁷ Therefore, the insider's failure to disclose

³⁶ See *Chiarella*, 445 U.S. at 224. The case provides no information about the circumstances that led to the discovery of Mr. Chiarella's alleged fraud. See *id.*

³⁷ See *id.* at 231 (quoting the judge's instructions to the jury).

³⁸ See *id.* at 225.

³⁹ See *id.*

⁴⁰ See *id.* at 233.

⁴¹ See *Chiarella*, 445 U.S. at 233.

⁴² See *id.* at 234.

⁴³ See *id.* at 232.

⁴⁴ See *id.* at 232, 235-36.

⁴⁵ See *id.* at 232.

⁴⁶ See *Chiarella*, 445 U.S. at 232 ("[Mr. Chiarella] was not a fiduciary . . . in whom the sellers had placed their trust and confidence.").

⁴⁷ See *id.* at 230 ("Application of a duty to disclose prior to trading guarantees that corporate

material, nonpublic information when trading in the corporation's stock is fraudulent and falls within the ambit of Rule 10b-5.⁴⁸ Mr. Chiarella, however, had no relationship with the target corporation.⁴⁹ Therefore, the Court concluded that he had no fiduciary duty to the corporation's shareholders.⁵⁰

The Court declined to decide whether Mr. Chiarella could be culpable under Rule 10b-5 for breaching his duty to the acquiring corporation by "misappropriating" its nonpublic information for his own use.⁵¹ There was no question that Mr. Chiarella breached a duty to his employer when he used information obtained in the course of his employment for his own personal trading purposes.⁵² Nevertheless, the Court determined that the jury instructions did not require Mr. Chiarella to have violated any duty for him to have been guilty of violating Rule 10b-5.⁵³ Thus, the Court ruled that the misappropriation theory was not at issue.⁵⁴ By so deciding, the Court missed an early opportunity to settle the ambiguity surrounding the misappropriation theory.⁵⁵

In his influential dissenting opinion in *Chiarella*, Chief Justice Burger argued that the misappropriation theory was properly charged in the case and that it was an acceptable basis for criminal liability under Rule 10b-5.⁵⁶ The Chief Justice agreed with the majority's assertion that there is no general duty to disclose material, nonpublic information before trading.⁵⁷ He explained that this lack of duty re-

insiders . . . will not benefit personally through fraudulent use of material, nonpublic information.").

⁴⁸ See *id.*

⁴⁹ See *id.* at 232-33.

⁵⁰ See *id.*

⁵¹ See *Chiarella*, 445 U.S. at 236. Justice Stevens wrote a separate concurring opinion to underscore the fact that no judgment had been made on the misappropriation theory's validity, and the Court's reversal of Mr. Chiarella's convictions did not necessarily mean that his actions were lawful. See *id.* at 238 (Stevens, J., concurring).

⁵² See *id.* at 235-36.

⁵³ See *id.* at 231 ("In effect, the trial court instructed the jury that petitioner owed a duty to everyone; to all sellers, indeed, to the market as a whole.").

⁵⁴ See *id.* at 236.

⁵⁵ See, e.g., *United States v. Bryan*, 58 F.3d 933, 949 (4th Cir. 1995) (rejecting the misappropriation theory); *United States v. Carpenter*, 791 F.2d 1024, 1026 (2d Cir. 1986) (adopting the misappropriation theory), *aff'd by an evenly divided court* 484 U.S. 19, 24 (1987).

⁵⁶ See 445 U.S. at 239 (Burger, C.J., dissenting). The Chief Justice's arguments that the misappropriation theory was properly charged in the jury instructions are not relevant to this Note; thus, the discussion will focus on the Chief Justice's arguments in favor of the misappropriation theory's validity.

⁵⁷ See *id.* at 239-40. ("As a general rule, neither party to an arm's-length business transaction has an obligation to disclose information to the other unless the parties stand in some confidential or fiduciary relation.").

flects a policy in favor of encouraging investors to gather and analyze as much relevant information as possible.⁵⁸ By allowing investors that do not act deviously to use informational advantages to reap profits, the law rewards those who are skilled in the art of gathering and analyzing market information.⁵⁹

Having defined his view of the policy underlying the lack of a general "disclose or abstain" rule, the Chief Justice argued that courts should use the Rule's policy underpinnings to define the Rule's limits.⁶⁰ The law encourages non-fraudulent gathering and analysis of information; thus, the Chief Justice argued, courts should not invoke the same policy concerns to protect those who obtain material, non-public information through fraudulent means.⁶¹ Mr. Chiarella's actions were fraudulent because he misappropriated the acquiring company's confidential information, without the acquiring company's permission and in violation of his fiduciary duty to his employer, the printer.⁶² By using the misappropriated information to reap profits in the securities markets, the Chief Justice argued, Mr. Chiarella violated Rule 10b-5.⁶³

Three years later, in 1983, the United States Supreme Court revisited the parameters of liability under Rule 10b-5 in *Dirks v. SEC*.⁶⁴ In *Dirks*, the Court overturned a conviction in an SEC proceeding against a broker who obtained information about fraud at a corporation and subsequently shared that information with investors, who traded in reliance on that information before it became public.⁶⁵ The Court reaffirmed its holding in *Chiarella* that there is no general duty for a person in possession of material, nonpublic information about a corporation to disclose the information before trading in the corporation's securities.⁶⁶ Citing *Chiarella*, the Court in *Dirks* ruled that a duty to disclose material, nonpublic information arises only where failure to do so would breach a duty that exists apart from the securities laws.⁶⁷

The defendant, Raymond Dirks, was an officer in a brokerage firm.⁶⁸ Mr. Dirks received information about alleged fraud at Equity Funding of America ("Equity") from an Equity employee.⁶⁹ Mr. Dirks

⁵⁸ See *id.* at 240.

⁵⁹ See *id.*

⁶⁰ See *id.*

⁶¹ See *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting).

⁶² See *id.* at 245.

⁶³ See *id.* at 240.

⁶⁴ 463 U.S. 646, 654-55 (1983).

⁶⁵ See *id.* at 648, 667.

⁶⁶ See *id.* at 654.

⁶⁷ See *id.*

⁶⁸ See *id.* at 648.

⁶⁹ See *Dirks*, 463 U.S. at 649.

investigated and verified the validity of the allegations.⁷⁰ Mr. Dirks called a *Wall Street Journal* reporter and urged him to write a story about the allegations, but the reporter declined to pursue the story.⁷¹ During the course of his investigation, Mr. Dirks informed his firm's clients and other investors about the problems at Equity.⁷² As a result, many Equity stockholders sold their interests in the corporation, and the price of Equity stock fell precipitously.⁷³ In response, the New York Stock Exchange halted trading.⁷⁴ Federal and state investigations of Equity resulted in many criminal indictments.⁷⁵

In addition, the SEC investigated Mr. Dirks's role in bringing the fraud at Equity to light.⁷⁶ In administrative proceedings, Mr. Dirks was found guilty of aiding and abetting violations of federal securities laws, including Rule 10b-5.⁷⁷ The SEC reasoned that "tippees" incur an obligation to "disclose or abstain" when they knowingly receive material, nonpublic information from corporate insiders.⁷⁸ The SEC censured Mr. Dirks but declined to impose more severe punishment, citing Mr. Dirks's role in exposing the fraud at Equity.⁷⁹ Nevertheless, Mr. Dirks appealed the SEC's ruling to the United States Court of Appeals for the District of Columbia, a divided panel that affirmed the SEC's judgment.⁸⁰

The Supreme Court began its analysis in *Dirks* by reaffirming its holding in *Chiarella* that there is no general duty to "disclose or abstain."⁸¹ Therefore, unless Mr. Dirks had a specific duty to disclose the nonpublic information, he did not violate Rule 10b-5.⁸² The SEC argued that Mr. Dirks assumed such a duty when he knowingly received information from Equity insiders, who certainly could not have traded on the nonpublic information that they provided to Mr. Dirks.⁸³

Rejecting the SEC's argument, the Court asserted that Equity employees who provided Mr. Dirks with nonpublic information had

⁷⁰ See *id.*

⁷¹ See *id.* at 649-50.

⁷² See *id.* at 649.

⁷³ See *id.* at 649, 650.

⁷⁴ See *Dirks*, 463 U.S. at 650.

⁷⁵ See *id.* at 650 & n.4. It was only after these investigations began to bear fruit that the *Wall Street Journal* published a story on the affair. Its account was based largely on information that Mr. Dirks supplied. See *id.* at 650.

⁷⁶ See *id.* at 650.

⁷⁷ See *id.* at 650-51.

⁷⁸ See *id.* at 651.

⁷⁹ See *Dirks*, 463 U.S. at 655-56.

⁸⁰ See *id.* at 652.

⁸¹ See *id.* at 654.

⁸² See *id.*

⁸³ See *id.* at 655-56.

not violated their fiduciary duty to Equity.⁸⁴ The Court reasoned that because the Equity employees violated no duty to their employer, Mr. Dirks had no duty to disclose that arose from those employees' duty to Equity.⁸⁵ Furthermore, Mr. Dirks had no independent duty to Equity.⁸⁶ Thus, the Court concluded that Mr. Dirks did not violate Rule 10b-5, and the Court overturned the lower court's judgment.

Despite the Supreme Court's ruling in *Dirks*, the Second Circuit continued to apply the misappropriation theory.⁸⁷ By so doing, the Second Circuit accepted the Supreme Court's determination that breach of a specific duty was a necessary element of liability under Rule 10b-5, but held that Rule 10b-5 did not require the party aggrieved by the breach of duty to be a party to the securities transaction that consummated the fraud.⁸⁸ The Seventh and Ninth Circuits followed the Second Circuit in endorsing the misappropriation theory.⁸⁹

In 1995, in *United States v. Bryan*, the Fourth Circuit became the first federal appellate court to reject the misappropriation theory.⁹⁰ The court held that the misappropriation theory failed to satisfy the requirement that the actor's fraud occur "in connection with the purchase or sale" of securities.⁹¹ Unlike the courts that embraced the misappropriation theory, the Fourth Circuit rejected the notion that a violation of Rule 10b-5 could be established by proving fraud, a securities transaction and a necessary connection between the two.⁹² Instead, the court read Rule 10b-5 as imposing one "single indivisible requirement" for liability.⁹³ The court held that misappropriation of material, nonpublic information, followed by the use of that information in a securities transaction, did not satisfy that unitary requirement.⁹⁴

In *Bryan*, the government charged the defendant, Elton Bryan, with mail fraud, wire fraud and perjury, in addition to violation of Rule

⁸⁴ See *Dirks*, 463 U.S. at 666, 666.

⁸⁵ See *id.* at 667.

⁸⁶ See *id.*

⁸⁷ See, e.g., *Carpenter v. United States*, 791 F.2d 1024, 1026 (2d Cir. 1986). The Supreme Court granted certiorari, but it deadlocked on the misappropriation issue. See *Carpenter v. United States*, 484 U.S. 19, 24 (1987). Thus, the validity of the misappropriation theory remained unsettled.

⁸⁸ See *Carpenter*, 791 F.2d at 1026, 1031.

⁸⁹ See *SEC v. Cherif*, 933 F.2d 403, 410 (7th Cir. 1991); *SEC v. Clark*, 915 F.2d 439, 453 (9th Cir. 1990).

⁹⁰ See 58 F.3d 933, 944 (4th Cir. 1995).

⁹¹ See *id.* at 950 (quoting Rule 10b-5).

⁹² See *id.*

⁹³ See *id.*

⁹⁴ See *id.*

10b-5.⁹⁵ All the charges arose from Mr. Bryan's actions during his tenure as director of West Virginia's state lottery.⁹⁶ A jury found him guilty of violating Rule 10b-5 because he profited from securities transactions that he made based on material, nonpublic information that was entrusted to him in the course of his employment.⁹⁷

Throughout its opinion, the Fourth Circuit emphasized the language of section 10(b), which requires "manipulation" or "deception."⁹⁸ Acknowledging that "manipulation" is a "term of art" in the securities field and that the term had no bearing in the instant case, the court focused on the deception requirement.⁹⁹ A deceptive act in this context, the court reasoned, could take two forms: (1) material misstatement of fact, or (2) breach of a duty to disclose.¹⁰⁰

The opinion presents no facts suggesting that a deceptive act of the first sort took place.¹⁰¹ Although the court acknowledged that Mr. Bryan's use of opportunities obtained in the course of his employment constituted a breach of his duty to his employer, it rejected the notion that such a breach falls within the purview of Rule 10b-5.¹⁰² Citing Supreme Court precedent, the Fourth Circuit concluded that "deception" within the meaning of section 10(b) applied only to deception of buyers, sellers, investors and other parties with a similar interest in a given securities transaction.¹⁰³ Any other reading, the court maintained, would render the language "in connection with the purchase or sale of any security" meaningless.¹⁰⁴

The Court elaborated on its decision that the misappropriation theory did not supply the required nexus between a deceptive act and a securities transaction.¹⁰⁵ The court viewed the misappropriation theory as an unacceptable effort to create a general duty to forgo transactions informed by material, nonpublic information.¹⁰⁶ The Fourth Circuit also expressed concerns that adoption of the misappropriation

⁹⁵ See *Bryan*, 58 F.3d at 936.

⁹⁶ See *id.* at 936, 937.

⁹⁷ See *id.* at 936.

⁹⁸ See *id.* at 945.

⁹⁹ See *id.* at 945-46. The element of deception required by the underlying statute does not seem to abridge the scope of Rule 10b-5, which requires fraud. See *supra* note 24 and accompanying text.

¹⁰⁰ See *Bryan*, 58 F.3d at 946.

¹⁰¹ See generally *id.*

¹⁰² See *id.* at 945, 950.

¹⁰³ See *id.* at 946.

¹⁰⁴ See *id.*

¹⁰⁵ See *Bryan*, 58 F.3d at 951.

¹⁰⁶ See *id.*

theory inevitably would result in a federal common law regulating fiduciary relationships.¹⁰⁷

In *Bryan*, the Fourth Circuit collapsed the elements of a Rule 10b-5 violation into a "single indivisible requirement."¹⁰⁸ Once it had done so, its rejection of the misappropriation theory necessarily followed.¹⁰⁹ The act of misappropriating nonpublic information is independent of the securities transaction in which that information is used for the personal benefit of the trader.¹¹⁰ Thus, by reading Rule 10b-5 and section 10(b) as dictating a "single indivisible requirement" for liability, the court begged the question of the misappropriation theory's validity.¹¹¹

II. RESOLVING THE CONFLICT: *UNITED STATES V. O'HAGAN*

The Fourth Circuit's decision in *Bryan* ignited a controversy over the misappropriation theory in the criminal context, and a mini-explosion of scholarship on the issue ensued.¹¹² The controversy heightened further when the Eighth Circuit followed the Fourth Circuit's lead in rejecting the misappropriation theory.¹¹³ In order to resolve the growing circuit split, the Supreme Court granted certiorari to review the Eighth Circuit's decision.¹¹⁴

In 1997, in *United States v. O'Hagan*, the Supreme Court endorsed the misappropriation theory in the criminal context.¹¹⁵ By doing so, the Court reinstated convictions of James O'Hagan, an attorney who had traded in securities with knowledge of material, nonpublic information that he had misappropriated from one of his law firm's corporate clients.¹¹⁶ The Court ruled that: (1) Mr. O'Hagan's breach of his fiduciary duty to his law firm and its client constituted fraud; and (2) the fraud occurred "in connection with the purchase or sale of securities."¹¹⁷

¹⁰⁷ See *id.* at 951-52.

¹⁰⁸ See *id.* at 950.

¹⁰⁹ See *Bryan*, 58 F.3d at 950.

¹¹⁰ See *id.* at 944.

¹¹¹ See *id.* at 950.

¹¹² See, e.g., Bayne, *supra* note 13, at 637 (arguing against the misappropriation theory's validity); Rosenbloom, *supra* note 13, at 867 (arguing in favor of the theory's validity).

¹¹³ See *United States v. O'Hagan*, 92 F.3d 612, 617 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997).

¹¹⁴ See *United States v. O'Hagan*, 521 U.S. 1087 (1997).

¹¹⁵ 521 U.S. 642, 650 (1997).

¹¹⁶ See *id.* at 678. The Court also reinstated Mr. O'Hagan's convictions under Exchange Act Rule 14e-3(a) and the federal mail fraud laws. See *id.* at 677, 678. Because the Eighth Circuit had not reached all the issues that Mr. O'Hagan had raised on appeal, the Supreme Court remanded the case to the Eighth Circuit for further proceedings. See *id.* at 678.

¹¹⁷ See *id.* at 653. Justice Ginsberg wrote the opinion for the Court.

Citing *Chiarella*, the Court asserted that the element of fraud in a violation of Rule 10b-5 required breach of a duty existing apart from federal securities law.¹¹⁸ In this case, Mr. O'Hagan clearly had breached fiduciary duties to both his law firm and its client.¹¹⁹ Even the dissenting Justices acknowledged that Mr. O'Hagan's conduct constituted fraud within the meaning of Rule 10b-5.¹²⁰

The Court next addressed the requirement that the fraud be committed "in connection with the purchase or sale of any security."¹²¹ The Court reasoned that Mr. O'Hagan's fraud was consummated not when he obtained the confidential information, but when he used that information for personal profit in the context of a securities transaction.¹²² Acknowledging that there are other conceivable uses for nonpublic information of the type that Mr. O'Hagan misappropriated, the Court made the common-sense assumption that most people would find such information valuable only in the context of its use in the securities markets.¹²³ The Court distinguished the facts of *O'Hagan* from a hypothetical situation where a person embezzled money, then used the ill-gotten funds to purchase securities.¹²⁴ Such a scheme would not fall within Rule 10b-5's prohibitions, the Court reasoned, because the fraud is complete when the money is obtained; the securities transaction is not an integral part of the fraud, as it is in a case involving misappropriated nonpublic information.¹²⁵

Having established that Rule 10b-5 encompasses the misappropriation theory, the Court justified its interpretation of the Rule in light of the policies underlying the federal securities laws.¹²⁶ The Court asserted that informational advantages obtained scurrilously could undermine investor confidence in securities markets.¹²⁷ Some actors might forgo securities investments altogether; others might incur ine-

¹¹⁸ See *id.* at 654 (citing RESTATEMENT (SECOND) OF AGENCY §§ 390, 395 (1958)).

¹¹⁹ See *id.*

¹²⁰ See *O'Hagan*, 521 U.S. at 679 (Scalia, J., dissenting) ("the Court's interpretation of . . . Rule 10b-5 would be entirely reasonable in some other context"); 521 U.S. at 680 (Thomas, J., dissenting) ("nondisclosure where there is a pre-existing duty to disclose satisfies our definitions of fraud and deceit for purposes of the securities laws.").

¹²¹ See *id.* at 655-56 (quoting Rule 10b-5).

¹²² See *id.* at 656.

¹²³ See *id.* at 657. This is perhaps a charitable characterization of the Court's fractured reasoning. The Court would have done better to stress that it was only Mr. O'Hagan's unauthorized use of the misappropriated information that violated his duties to his law firm and its client. In this sense, *O'Hagan* is an easy case; it would be harder to argue that Rule 10b-5 was applicable where nonpublic information was acquired in a fraudulent way.

¹²⁴ See *id.* at 656-57.

¹²⁵ See *O'Hagan*, 521 U.S. at 656-57.

¹²⁶ See *id.* at 658-59.

¹²⁷ See *id.* at 658.

efficient costs in an effort to avoid dealing with unscrupulous investors.¹²⁸ If the law is to prevent these deleterious effects, the Court reasoned, it makes no sense to distinguish between traditional insiders and misappropriators of material, nonpublic information.¹²⁹ The language of Rule 10b-5 and section 10(b) is amenable to a broad interpretation, the Court reasoned, and the Court determined that policy considerations favored a broad reading in this case.¹³⁰

Despite its endorsement of the broad policy concerns underlying Rule 10b-5, the Court ultimately adopted a narrower conception of the misappropriation theory in *O'Hagan* than Chief Justice Burger had advocated in his dissenting opinion in *Chiarella*.¹³¹ Whereas Chief Justice Burger's theory would have required possessors of misappropriated, material, nonpublic information to disclose that information to other parties in a securities transaction, the theory adopted by the Court in *O'Hagan* only requires the actor to disclose his or her intentions to the source of the information.¹³² The Court acknowledges that the trader's disclosure of his intentions to the source of the material, nonpublic information does little to advance the policy goals of Rule 10b-5.¹³³ Nevertheless, the Court concluded that the language of Rule 10b-5 requires this result.¹³⁴ Where the trader has made full disclosure to the source of the information, there has been no breach of the trader's duty to the source of the information, and thus there can be no liability under Rule 10b-5.¹³⁵

¹²⁸ See *id.* at 659.

¹²⁹ See *id.* The Court does not consider the argument that the victims of traditional insiders have a right to expect those insiders to deal fairly with them because the parties have a fiduciary relationship. As Justice Cardozo famously said, "[m]any forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties." *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928). Traditionally, the law has not imposed duties of loyalty upon parties to a discrete transaction, who presumably are "acting at arm's length." See *id.* Although the arguments in favor of interpreting the securities law to create such a duty are strong, it would hardly have been unprecedented or illogical for the Court to reach the contrary conclusion, particularly in light of the Court's prior, repeated insistence that Rule 10b-5 penalizes only violations of duties that exist apart from federal securities law. See, e.g., *Dirks v. SEC*, 463 U.S. 646, 654 (1983).

¹³⁰ See *O'Hagan*, 521 U.S. at 659.

¹³¹ See *id.* at 655 n.6. ("The Government does not propose that we adopt a misappropriation theory of that breadth."); *Chiarella v. United States*, 445 U.S. 222, 240 (Burger, C.J., dissenting).

¹³² See *O'Hagan*, 521 U.S. at 655 n.6; *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting).

¹³³ See *O'Hagan*, 521 U.S. at 659 n.9 ("[S]uch conduct may affect the securities markets in the same manner as the conduct reached by the misappropriation theory. [Nevertheless,] the fact that § 10(b) is only a partial antidote . . . does not call into question its prohibition of conduct that falls within its textual proscription.").

¹³⁴ See *id.*

¹³⁵ See *id.* at 656.

Justice Scalia dissented from the Court's reinstatement of Mr. O'Hagan's convictions under Rule 10b-5.¹³⁶ In a brief opinion, Justice Scalia acknowledged that the majority's interpretation of Rule 10b-5 was reasonable.¹³⁷ He argued, however, that the majority's expansive reading was not appropriate in a criminal case like *O'Hagan*.¹³⁸ In light of the general principle that courts should construe ambiguity in criminal statutes in favor of lenity, Justice Scalia argued that the Court should have construed the language "in connection with the purchase or sale of any security" to require fraud on a party to a securities transaction.¹³⁹

Justice Thomas, joined by Chief Justice Rehnquist, also dissented.¹⁴⁰ Justice Thomas agreed with the Court's determination that Mr. O'Hagan's actions constituted fraud within the meaning of Rule 10b-5.¹⁴¹ Justice Thomas disagreed, however, with the Court's ruling that the fraud occurred "in connection with the purchase or sale" of securities.¹⁴² He argued that the government's version of the misappropriation theory was unworkable, and that the Court had improperly substituted its own version of the misappropriation theory in place of the government's proffered theory.¹⁴³

Justice Thomas attacked the majority's distinction between the use of misappropriated information in a securities transaction, which is a violation of Rule 10b-5, and the use of misappropriated money in a securities transaction, which is not a violation.¹⁴⁴ He rejected the majority's assertion that the fraud in the latter case is complete when the wrongdoer obtains the money, but the fraud in the former case is consummated only when the wrongdoer uses the information in a securities transaction.¹⁴⁵ He argued that information, like money, has many potential uses.¹⁴⁶ Thus, Justice Thomas argued, the misappropriation

¹³⁶ See *id.* at 679 (Scalia, J., dissenting).

¹³⁷ See *id.*

¹³⁸ See *O'Hagan*, 521 U.S. at 679.

¹³⁹ See *id.*

¹⁴⁰ See *id.* at 680-701 (Thomas, J., dissenting). Many powerful arguments can be made against the validity of the misappropriation theory. See, e.g., *id.* at 679 (Scalia, J., dissenting); *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995). Unfortunately, Justice Thomas's dissent fails to do justice to these arguments.

¹⁴¹ See *O'Hagan*, 521 U.S. at 680 (Thomas, J., dissenting).

¹⁴² See *id.* (quoting Rule 10b-5).

¹⁴³ See *id.* at 681, 687.

¹⁴⁴ See *id.*

¹⁴⁵ See *id.* at 681-83, 682-85 ("[W]hen the majority seeks to distinguish the embezzlement of funds from the embezzlement of information, it becomes clear that neither the [SEC] nor the majority has a coherent theory . . .").

¹⁴⁶ See *O'Hagan*, 521 U.S. at 685 (Thomas, J., dissenting).

tor of material, nonpublic information has completed a fraud when that information is obtained wrongfully.¹⁴⁷

The majority conceded that the government overstated its argument when it stated that the misappropriator's "only" possible use for material, nonpublic information is its use in a securities transaction.¹⁴⁸ Justice Thomas seized on this admission by the majority.¹⁴⁹ He accused the majority of violating a basic principle of administrative law by fashioning an alternative explanation for the SEC after rejecting the SEC's own explanation.¹⁵⁰ He also noted that the Court's determination that misappropriated nonpublic information is "ordinarily" only valuable in the context of a securities transaction was unsupported by factual findings.¹⁵¹

III. CIVIL ACTIONS UNDER RULE 10b-5 AND THE MISAPPROPRIATION THEORY

Section 10(b) and Rule 10b-5 are criminal enactments.¹⁵² Nevertheless, courts have long recognized a private cause of action for persons who are harmed by violations of Rule 10b-5.¹⁵³ Because civil actions under Rule 10b-5 further the goals of federal securities regulation, such actions have been an important part of securities regulation for many years.¹⁵⁴

In 1946, in *Kardon v. National Gypsum Co.*, the United States District Court for the Eastern District of Pennsylvania held that a private cause of action exists under Rule 10b-5.¹⁵⁵ Although only a district court opinion, *Kardon* today is acclaimed as a landmark case in securities law.¹⁵⁶ The court based its holding on the policies underlying tort law and the federal securities laws.¹⁵⁷

¹⁴⁷ See *id.* Justice Thomas does not consider that the mere possession of nonpublic information generally does not entail a breach of fiduciary duty.

¹⁴⁸ See *id.* at 657.

¹⁴⁹ See *id.* at 687 (Thomas, J., dissenting).

¹⁵⁰ See *id.* (citing *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983)).

¹⁵¹ See *O'Hagan*, 521 U.S. at 688.

¹⁵² See 15 U.S.C. § 78j(b) (1994); 17 C.F.R. § 240.10b-5 (1997).

¹⁵³ See *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946).

¹⁵⁴ See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975).

¹⁵⁵ 69 F. Supp. at 514.

¹⁵⁶ See *id.* *Kardon* has been cited in 11 different Supreme Court opinions. See *Blue Chip Stamps*, 421 U.S. at 730. It was well-settled that Rule 10b-5 created a private right of action by the time the Supreme Court addressed the issue. See *id.*

¹⁵⁷ See *Kardon*, 69 F. Supp. at 513, 514.

The plaintiffs in *Kardon* alleged that the defendants persuaded them to sell stock for considerably less than its true value.¹⁵⁸ The plaintiffs alleged they sold the stock because of misrepresentations made by the defendants.¹⁵⁹ The court accepted without discussion the assertion that the alleged conduct, if proven in a criminal case, would constitute a violation of Rule 10b-5.¹⁶⁰

Although the defendants' alleged conduct undisputedly ran afoul of Rule 10b-5, the defendants argued that the plaintiffs had no cause of action based on that provision.¹⁶¹ In support of their argument, the defendants noted that several other provisions of the Securities Exchange Act of 1934 expressly provided civil remedies for parties aggrieved by violations of those provisions.¹⁶² Because section 10(b) lacked such a provision, the defendants argued, the court could infer that Congress intended to deny parties like the plaintiffs a cause of action based on section 10(b).¹⁶³

Although the court acknowledged that the defendants' argument based on statutory construction was strong, it nonetheless rejected the argument.¹⁶⁴ Instead, the court focused on the broad purpose of the Exchange Act—regulation of securities transactions of all kinds.¹⁶⁵ Rule 10b-5 condemns manipulative and deceptive practices in the securities markets.¹⁶⁶ The defendants' alleged conduct, if proven, clearly would fall within the realm of activities condemned by Rule 10b-5.¹⁶⁷

Applying traditional principles of tort law, the court stated that a private cause of action may be inferred from a criminal statute unless the legislature explicitly forecloses such a right.¹⁶⁸ Neither the Exchange Act in general nor section 10(b) in particular, the court determined, expresses a clear congressional intent to foreclose private causes of action.¹⁶⁹ The court asserted that the violation of a statute constitutes a tort, and in light of the lack of language foreclosing a

¹⁵⁸ See *id.* at 513.

¹⁵⁹ See *id.*

¹⁶⁰ See *id.* ("It . . . cannot be questioned that the complaint sets forth conduct . . . directly in violation of the provisions of [Rule 10b-5].").

¹⁶¹ See *id.*

¹⁶² See *Kardon*, 69 F. Supp. at 514.

¹⁶³ See *id.*

¹⁶⁴ See *id.*

¹⁶⁵ See *id.*

¹⁶⁶ See *id.*

¹⁶⁷ See *Kardon*, 69 F. Supp. at 513.

¹⁶⁸ See *id.* at 513-14.

¹⁶⁹ See *id.* at 514.

private cause of action under Rule 10b-5, the court allowed the plaintiffs' action to proceed.¹⁷⁰

The court in *Kardon* relied on a wide range of policies to support its holding that a plaintiff could maintain a civil suit based on conduct violative of Rule 10b-5.¹⁷¹ First, the violation of a criminal statute generally is considered a tort.¹⁷² Therefore, parties who are victimized by criminal activity may maintain a suit for damages against the wrongdoer, unless such a right is explicitly denied by the legislature.¹⁷³ Second, the purpose of Rule 10b-5 is the proscription of manipulative and deceptive practices in securities markets.¹⁷⁴ By permitting private actions based on violations of Rule 10b-5, the courts assist the SEC in effectuating Congress's goals under the Exchange Act.¹⁷⁵ Lastly, Congress enacted federal securities laws for the benefit of investors.¹⁷⁶ Recognizing a private cause of action furthers the interests of investors by allowing investors that are harmed by violations of Rule 10b-5 to seek judicial redress of their injuries.¹⁷⁷

In 1983, in *Moss v. Morgan Stanley, Inc.*, the Second Circuit held that the misappropriation theory may not serve as the basis for a lawsuit under Rule 10b-5 by a party to whom the misappropriator owes no duty apart from the securities laws.¹⁷⁸ The court's analysis in *Moss* focused on the lack of any specific duty owed by the defendants to the plaintiffs.¹⁷⁹ The court reasoned that because no such duty existed, the plaintiffs had no cause of action against the defendants, even though the plaintiffs alleged that they were injured by the defendants' illegal activities.¹⁸⁰

Moss was a class-action suit, brought on behalf of all shareholders who sold stock in a company just before a tender offer was made for that company's stock.¹⁸¹ The defendants in *Moss* were an investment banking firm and several of its fiduciaries.¹⁸² Two of the individual

¹⁷⁰ See *id.* at 513, 514.

¹⁷¹ See *id.* at 513-14.

¹⁷² See *Kardon*, 69 F. Supp. at 513.

¹⁷³ See *id.* at 514.

¹⁷⁴ See *id.*

¹⁷⁵ See *id.*

¹⁷⁶ See *id.*

¹⁷⁷ See *Kardon*, 69 F. Supp. at 513.

¹⁷⁸ 719 F.2d 5, 16 (2d Cir. 1983).

¹⁷⁹ See *id.*

¹⁸⁰ See *id.* at 13 ("[T]he district court was correct in concluding that 'plaintiff cannot hope to piggyback upon the duty owed by defendants'").

¹⁸¹ See *id.* at 8.

¹⁸² See *id.* at 8-9.

defendants had received criminal convictions under the misappropriation theory of Rule 10b-5 for the conduct at issue in *Moss*.¹⁸³

The Second Circuit considered and rejected three possible sources from which the defendants in *Moss* could be said to owe a duty to the class of plaintiffs.¹⁸⁴ Most significantly, the court held that the defendants' admittedly criminal conduct did not expose them to civil liability for injuries caused by their criminal acts, except to the extent that the defendants had some pre-existing duty to those parties.¹⁸⁵ The court also rejected arguments that the defendants actually were insiders of the target corporation.¹⁸⁶

The existence of a private cause of action under Rule 10b-5 has been settled for many years now.¹⁸⁷ Nevertheless, *Moss* remains the only appellate-level case involving the validity of the misappropriation theory in the civil context. The Supreme Court's opinion in *O'Hagan* did not address the issue.¹⁸⁸

IV. ANALYSIS: EXPANDING THE LAW TO PROMOTE JUSTICE

A. *Into the Abyss: Scrutinizing the Logic of O'Hagan*

In *O'Hagan*, the Supreme Court upheld the validity of the misappropriation theory.¹⁸⁹ An abundance of case law on the misappropriation theory had developed in lower courts during the seventeen years after *Chiarella*, but neither the majority nor the dissenters made much use of this body of case law in their opinions in *O'Hagan*.¹⁹⁰ Instead, the *O'Hagan* opinions rely primarily on novel arguments, supported by snippets of reasoning from prior Supreme Court cases that presented issues quite different from the issues in *O'Hagan*.¹⁹¹

¹⁸³ See *Moss*, 719 F.2d at 9 n.6.

¹⁸⁴ See *id.* at 13-15.

¹⁸⁵ See *id.* at 13.

¹⁸⁶ See *id.* at 13-14. Of course, if the defendants were traditional insiders, the plaintiffs would have had a cause of action. See *Kardon*, 69 F. Supp. at 514.

¹⁸⁷ See *Blue Chip Stamps*, 421 U.S. at 730.

¹⁸⁸ See generally *O'Hagan*, 521 U.S. at 642.

¹⁸⁹ See *id.* at 650.

¹⁹⁰ The Court's only mention of these lower-court decisions comes in a footnote in the majority opinion. See *id.* at 650 n.3 (citing *United States v. Chestman*, 947 F.2d 551, 566 (2d Cir. 1991); *SEC v. Cherif*, 933 F.2d 403, 410 (7th Cir. 1991); *SEC v. Clark*, 915 F.2d 439, 453 (9th Cir. 1990)). The Court also virtually ignores *Carpenter v. United States*, 484 U.S. 19, 24 (1987), where the Court deadlocked on the issue of the misappropriation theory's validity.

¹⁹¹ See *O'Hagan*, 521 U.S. at 656-57 (distinguishing misappropriation of information from theft of money); *id.* at 679 (Scalia, J., dissenting) (arguing that principle of lenity in interpretation of criminal statutes forecloses enforcement of misappropriation theory in the criminal context); *id.* at 687 (Thomas, J., dissenting) (citing *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins.*

One of the most striking aspects of the majority opinion in *O'Hagan* is the nonchalance with which the Court dismissed language from its opinion in *Chiarella*.¹⁹² The Court correctly notes that *Chiarella* expressly leaves open the question of the misappropriation theory's validity.¹⁹³ When the Eighth Circuit rejected the misappropriation theory, however, that court was influenced by the Supreme Court's statement in *Chiarella* that liability under Rule 10b-5 "is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction."¹⁹⁴ The Supreme Court disavowed any intention to reject this language, instead maintaining that these statements were intended merely to "[reject] the notion that section 10(b) stretches so far as to impose a general duty between all participants in market transactions to forgo actions based on material, nonpublic information."¹⁹⁵ Although the Court ignores the issue, its decision in *O'Hagan* effectively limits *Chiarella* to this narrow holding.¹⁹⁶

Like the majority opinion, Justice Thomas's dissenting opinion attempts to break new ground.¹⁹⁷ The government maintained at oral argument that use of misappropriated information in a securities transaction violates Rule 10b-5, whereas use of misappropriated money in a securities transaction does not violate the Rule.¹⁹⁸ Justice Thomas argued that there is no difference, for purposes of the securities laws, between misappropriation of information and misappropriation of money for use in securities transactions.¹⁹⁹ Justice Thomas's argument, however, is misplaced; Mr. O'Hagan probably did not commit a fraud against his law firm and its client merely by obtaining the information.²⁰⁰ Rather, the fraud occurred only when he used the information in the securities markets, thereby "misappropriating" it for his own use.²⁰¹ However typical or atypical the facts of *O'Hagan* may have been, the case was easily distinguishable from a hypothetical case involving the use of misappropriated money in a securities transaction.²⁰²

Co., 463 U.S. 129, 143 (1983)) (arguing that misappropriation theory cannot be applied against Mr. O'Hagan because the SEC's explanation of theory to the Court was flawed).

¹⁹² See *id.* at 662.

¹⁹³ See *id.*

¹⁹⁴ See *United States v. O'Hagan*, 92 F.3d 612, 618 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997) (quoting *Chiarella v. United States*, 445 U.S. 222, 230 (1980) (emphasis added)).

¹⁹⁵ See *O'Hagan*, 521 U.S. at 662.

¹⁹⁶ See *id.*

¹⁹⁷ See *id.* at 681-85, 687 (Thomas, J., dissenting).

¹⁹⁸ See *id.* at 683-84 (citing the transcript from oral argument).

¹⁹⁹ See *id.* at 686.

²⁰⁰ See *O'Hagan*, 521 U.S. at 647-48, 648 n.1.

²⁰¹ See *id.* at 656.

²⁰² See *id.* at 681-85 (Thomas, J., dissenting).

The majority's modification of the government's version of the misappropriation theory evokes the most heated criticism in Justice Thomas's dissent.²⁰³ He argued that the majority must accept or reject the SEC's version of the misappropriation theory *in toto*.²⁰⁴ The case upon which he relied—*Motor Vehicle Manufacturers Association v. State Farm Mutual Automobile Insurance Co.*—however, has little relevance to *O'Hagan*.²⁰⁵ *State Farm* involved a challenge to an agency's rulemaking process; in *O'Hagan*, no one contested the validity of Rule 10b-5.²⁰⁶ Furthermore, the Court's insistence on sound agency reasoning in *State Farm* was sensible, given the great deference that courts give to agency action in such circumstances.²⁰⁷ In his dissent in *O'Hagan*, Justice Scalia correctly criticized Justice Thomas for failing to distinguish cases where agency action receives "*Chevron* deference" from cases like *O'Hagan*, where agency reasoning has no more legal significance than any other argument made by a party during litigation.²⁰⁸

B. Expanding the Misappropriation Theory to Promote Consistent Justice

In light of the policies favoring private actions under Rule 10b-5, the right to bring such actions should extend to investors who are victimized by persons who trade on the basis of misappropriated, material, nonpublic information.²⁰⁹ This is especially so now that *O'Hagan* has settled the validity of the misappropriation theory in the criminal context.²¹⁰ Recognizing such a right of action is consistent with the principle that the violation of a criminal statute is a tort.²¹¹ Courts should compel those who violate the law to compensate the victims of their unlawful activity.²¹² Such an obligation furthers the purposes of

²⁰³ See *id.* at 687.

²⁰⁴ See *id.*

²⁰⁵ See generally *O'Hagan*, 521 U.S. 642; *State Farm*, 463 U.S. at 39. In *State Farm*, the Court held that rescission of a regulation by the Department of Transportation was arbitrary and capricious, in violation of the Administrative Procedure Act. See *State Farm*, 463 U.S. at 39. Although conceding that a reasonable explanation for the agency's action could be formulated, the Court refused to supply a reasoned basis for the agency's decision that the agency itself had failed to supply. See *State Farm*, 463 U.S. at 43.

²⁰⁶ See *State Farm*, 463 U.S. at 39.

²⁰⁷ See *id.* at 43.

²⁰⁸ See *O'Hagan*, 521 U.S. at 679 (Scalia, J., dissenting); *Chevron U.S.A. v. Natural Resources Defense Council*, 467 U.S. 837, 843-44 (1984) (ruling that courts must give an agency's interpretation of a statute controlling weight, unless that interpretation is manifestly contrary to congressional intent). *Chevron* involved a challenge to the validity of an EPA regulation promulgated pursuant to the Clean Air Act. See 467 U.S. at 840-41.

²⁰⁹ See *O'Hagan*, 521 U.S. at 658-59 (detailing policy considerations behind section 10(b) and Rule 10b-5); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513-14 (E.D. Pa. 1946).

²¹⁰ See *O'Hagan*, 521 U.S. at 650.

²¹¹ See *Kardon*, 69 F. Supp. at 513.

²¹² See *id.*

the securities laws which, post-*O'Hagan*, clearly proscribe the misappropriation of material, nonpublic information for use in securities transactions.²¹³ Furthermore, imposing such a duty would protect the investing public, which is ultimately the intended beneficiary of the securities laws.²¹⁴

The policy considerations cited in *Kardon* favor the allowance of civil actions based on the misappropriation theory of Rule 10b-5 liability.²¹⁵ First, because the violation of a criminal statute is a tort, parties who are victimized by such a violation should be allowed to maintain a suit for damages against the wrongdoer, unless the legislature specifically forecloses such a right.²¹⁶ Second, the purpose of Rule 10b-5 is the proscription of manipulative and deceptive practices in securities markets.²¹⁷ By permitting private actions based on both the traditional and misappropriation theories of Rule 10b-5, the courts would assist the SEC to the greatest extent possible in effectuating Congress's intentions.²¹⁸ Lastly, Congress enacted federal securities laws for the benefit of investors.²¹⁹ Allowing a private right of action for damages caused by Rule 10b-5 "misappropriation" would further the interests of investors by allowing them to seek judicial redress for injuries caused by criminal conduct.²²⁰

Failure to extend the misappropriation theory to the civil context would frustrate the policy objectives favoring civil actions under Rule 10b-5.²²¹ The general policy of tort law favoring private rights of action for statutory violations would be compromised needlessly.²²² Failure to extend the misappropriation theory to the civil context also would compromise the central purpose of Rule 10b-5—the prevention of manipulative and deceptive practices in the securities markets.²²³ Civil actions complement enforcement actions by the SEC and the Justice Department, thereby expanding the reach and enhancing the effectiveness of Rule 10b-5.²²⁴

²¹³ See *O'Hagan*, 521 U.S. at 650.

²¹⁴ See *Kardon*, 69 F. Supp. at 514.

²¹⁵ See *id.* at 513-14.

²¹⁶ See *id.*

²¹⁷ See *id.* at 514.

²¹⁸ See *id.*

²¹⁹ See *Kardon*, 69 F. Supp. at 514.

²²⁰ See *id.* at 513.

²²¹ See *O'Hagan*, 521 U.S. at 658-59; *Kardon*, 69 F. Supp. at 513-14.

²²² See *Kardon*, 69 F. Supp. at 514.

²²³ See *id.*

²²⁴ See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975).

Few lawsuits have been brought to date under the misappropriation theory of Rule 10b-5, perhaps due to the courts' unwillingness in recent years to entertain novel private causes of action under Rule 10b-5.²²⁵ Nevertheless, there is no principled distinction between traditional insiders and misappropriators of nonpublic information.²²⁶ Courts that focus on the absence of duty owed by a misappropriator to actors in the securities markets essentially require the plaintiff to prove the common law elements of fraud.²²⁷ By doing so, these courts effectively nullify the benefits of allowing private causes of action under Rule 10b-5, because aggrieved persons are not afforded any rights under the Rule that were not previously afforded to them under state law.²²⁸

The arguments against the misappropriation theory in the criminal context are not without merit.²²⁹ Nevertheless, *O'Hagan* has resolved this controversy in favor of the misappropriation theory's validity.²³⁰ In light of this reality, there is no good reason to distinguish between misappropriators and traditional insiders, thereby denying the victims of the former the right to seek restitution under Rule 10b-5.²³¹

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²²⁵ See, e.g., *Blue Chip Stamps*, 421 U.S. 723 (establishing limits on private causes of action under Rule 10b-5).

²²⁶ See *O'Hagan*, 521 U.S. at 659 ("It makes scant sense to hold a lawyer like O'Hagan a § 10(b) violator if he [misappropriates nonpublic information], but not if he works for a law firm [representing the company, thereby making him an insider]. The text of the statute requires no such result.").

²²⁷ See *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5, 16 (2d Cir. 1983).

²²⁸ See *Kardon*, 69 F. Supp. at 513.

²²⁹ See, e.g., *O'Hagan*, 521 U.S. at 679 (Scalia, J., dissenting); *United States v. Bryan*, 58 F.3d 933, 950 (4th Cir. 1995); see generally Bayne, *supra* note 13.

²³⁰ See *O'Hagan*, 521 U.S. at 650.

²³¹ See *id.*