No. 96-842

IN THE

Supreme Court of the United States

OCTOBER TERM, 1996

UNITED STATES OF AMERICA,

Petitioner,

v.

JAMES HERMAN O'HAGAN,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF *AMICI CURIAE* LAW PROFESSORS AND COUNSEL IN SUPPORT OF RESPONDENT

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Consent of Parties

The consents of Petitioner and Respondent to the filing of this brief have been filed with the Clerk of the Court.

Interest of Amici

Amici are professors of securities regulation or counsel for clients who participate in the securities markets. Amici are interested in the predictable interpretation of the securities laws in accordance with the statutory text and purpose. Amici have not received any compensation with respect to this brief.[1]

Although some Commentators argue that trading by corporate insiders (hereinafter "insider trading") should be legal, amici find the arguments for prohibition of insider trading more compelling.[2] Congress, however, has not specified when it is also illegal for persons who are not corporate insiders, such as the Respondent in this case, to trade while in possession of material nonpublic information. For this reason, and recognizing that there are other civil

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[1] This brief was authored by the law professors listed on the front cover hereof, and was not authored by counsel for a party. No one other than amici has made any monetary contribution to the preparation of this brief. This brief addresses one of the issues before the Court in this case, the misappropriation theory. Amici take no position on the applicability of Rule 14e-3 or the mail fraud statute to this case.

[2] *Compare, e.g.*, Henry G. Manne, *Insider Trading and the Stock Market* (1966) (insider trading should be legalized) with William H. Painter, *The Federal Securities Code and Corporate Disclosure* 235-50 (1979) (insider trading undermines investor confidence and compensates insiders irrespective of risk or effort).

and criminal penalties available against such traders,[3] amici urge this Court to affirm the holding below that the misappropriation theory is not authorized by the Securities Exchange Act (the "1934 Act").

Summary of Argument

1. Section 10(b) proscribes "manipulative or deceptive" practices "in connection with the purchase or sale of any security." This Court has concluded that it is a deceptive practice for a corporate insider to trade on the basis of material nonpublic information without first disclosing the information, but that corporate "outsiders" have no similar duty to disclose. *Chiarella v. United States*, 445 U.S. 222, 227-28 (1980).

Respondent was not an insider of the corporation whose shares he traded. His use of information belonging to his employer's client may be described as "conversion" or "misappropriation," but does not implicate the investor protection concerns of this Court after *Chiarella*. Absent a "material misrepresentation or material failure to disclose," Respondent's use of information was not "deception" as that

[3] The Brief *Amici Curiae* North American Securities Administrators Association, Inc., and Law Professors in Support of Petitioner (the "NASAA Brief") asserts that apart from any § 10(b) violations, the "federal mail and wire fraud statutes independently prohibit most misappropriation." *Id.* at 6, citing *Carpenter v. United States*, 484 U.S. 19 (1987). A lawyer could also be sued under state agency law for misappropriation of information entrusted to his law firm by a client, *see* note 23 *infra*, and could perhaps be disbarred for such conduct. *See* note 20 *infra*.

term is used in §10(b). *Santa Fe Indus. v. Green*, 430 U.S. 462, 474 (1977).

Even if this Court departs from its prior interpretation of §10(b) by choosing to equate misappropriation with deception, Respondent's misappropriation did not occur "in connection with" the purchase or sale of a security. If anyone was deceived by Respondent, it was his employer and the employer's clients, not a person who bought or sold securities at the time Respondent did. This straightforward reading of the statute is further bolstered by the context of the 1934 Act: Congress's objective was to protect the integrity of securities markets, not to provide a general remedy for thefts of information. Furthermore, Congress has taken no action since 1934 that should cause this Court to alter its interpretation of §10(b).

2. Because the misappropriation theory is inconsistent with this Court's prior interpretation of §10(b), the case law applying the theory has been contradictory, and in criminal cases impermissibly vague. Such a theory simply cannot stand up to the due process scrutiny that is ordinarily applied by this Court to criminal statutes.

3. If this Court chooses to adopt the misappropriation theory, this Court will have to define its parameters far more clearly than the appellate courts have done so far. In doing so, this Court will have to develop a federal common law of fiduciary duty, or condition §10(b) liability on breach of state fiduciary duty law. In either case, this Court's definition of the misappropriation theory will take it far afield from the distinction made in *Santa Fe* between deception and breach of fiduciary duty. *Santa Fe*, 430 U.S. at 474-77.

4. Instead, this Court should reject the misappropriation theory and allow Congress to change the statutory prohibition if it so desires. Congress could impose on all traders a general duty to disclose material nonpublic information, and then set forth specific exceptions. Congress could also create for certain persons a federal property right in information, much like that created by courts using the misappropriation theory. Alternatively, Congress could adhere to the approach it has adhered to since 1934 and leave §10(b) alone.

Argument

I. The Misappropriation Theory is Inconsistent with this Court's Prior Interpretation of the 1934 Act.

A. *The misappropriation theory is inconsistent with the language and purpose of Section 10(b).*

With respect to "the scope of conduct prohibited by §10(b), the text of the statute controls [the Court's] decision." *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1446 (1994). This Court has "refused to allow 10b-5 challenges to conduct not prohibited by the text of the statute." *Id.* Unfortunately, the text of §10(b) does not even mention insider trading, and Congress probably did not envision insider trading as coming within the proscriptions of §10(b).[4] The federal courts for almost thirty years, however, have held that trading by corporate insiders in possession of material nonpublic information is a "deceptive" device in violation of § 10(b) and Rule 10b-5.

Many courts and commentators before 1980 interpreted §10(b) and Rule 10b-5 not only to prohibit insider trading, but also to require *any* person in possession of material nonpublic information to disclose that information to the market or to abstain from trading (the "parity of information theory"). *See SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). This Court, however, substantially narrowed the scope of §10(b)'s prohibition in 1980 when an employee of a financial printer was charged with trading on information obtained from his employer. This Court had been urged by the Government to adopt the parity of information theory and impose a duty to "disclose or abstain" from trading, as had been established in *Texas Gulf Sulphur*, but this Court declined to infer such a duty from the statute. "When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak." *Chiarella*, 445 U.S. at 235. As this Court explained, *id.* at 232, such a duty could not:

> arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence.

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[4] "The conventional wisdom is that Congress enacted section 9 [prohibiting manipulation of security prices] to deal with manipulation and expressed its concern with insiders' informational advantage by enacting section 16 [denying insiders short-swing profits]." Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 Va. L. Rev. 1, 56-57 (1980). *See also* Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 Wash & Lee L. Rev. 1189, 1229 (1995).

Although this Court rejected the parity of information theory, this Court's holding in *Chiarella* at least focused on the same issue as the parity of information theory: the scope of Chiarella's duty to investors in the company whose shares he traded or to the company in which they had invested ("But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence *between parties to a transaction.*" *Chiarella*, 445 U.S. at 230 (emphasis added)). It is true that Chiarella's breach of his duty to yet another party, his employer's customer (the acquiring corporation), was argued by the Government on appeal as an alternative basis on which to impose liability. *Id.* at 235. This basis for liability was endorsed by the Chief Justice in his dissenting opinion. *Id.* at 240. A theory based upon protection of Chiarella's employer or its customers, however, was not even argued by the Government to the jury. *Id.* at 236. The explanation for this omission presumably was not ineptitude, but logic: whether or not the 1934 Act imposed a general duty on all persons to disclose material nonpublic information before trading, the statute was not designed to condition a duty to disclose on a corporate outsider's relationship either with his employer or derivatively with his employer's customers.[5]

In 1983, this Court again focused on the duties that investors owe to each other:

[5] In *Chiarella*, this Court held that §10(b) is not violated "unless the trader has an independent duty of *disclosure*." *Central Bank*, 114 S. Ct. at 1446 (emphasis added). This duty of "disclosure" is one that logically can only be owed to investors in the market, not to the source of nonpublic information (who presumably already knows the information and would want to keep it confidential).

> We were explicit in *Chiarella* in saying that there can be no duty to disclose where the person who has traded on inside information "was not [the corporation's] agent,. . . was not a fiduciary, [or] was not a person in whom the *sellers* [of the securities] had placed their trust and confidence." 445 U.S. at 232. Not to require such a fiduciary relationship, we recognized, would "depar[t] radically from the established doctrine that duty arises from a specific relationship *between two parties*" and would amount to "recognizing a general duty between all *participants in market transactions* to forgo actions based on material, nonpublic information." *Id.* at 232, 233.

Dirks v. SEC, 463 U.S. 646, 654-55 (1983) (emphasis added). A tippee is thus liable if he "knew the information was given to him in breach of a duty by a person having a special relationship *to the issuer* not to disclose the information...." *Id.* at 661 (emphasis added) (quoting *In re Investors Management Co.*, 44 S.E.C. 633 (1971)). The critical issue in *Dirks*, as in *Chiarella*, was whether the trader (or in *Dirks*, the trader's tipper) had a duty to investors or to the corporation in which those investors owned stock. *See Dirks*, 463 U.S. at 663, n. 23 ("a violation may be found only where there is 'intentional or willful conduct designed to deceive or defraud *investors* . . .'") (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. at 199) (emphasis supplied); *Chiarella*, 445 U.S. at 230 (a duty to disclose under §10(b) arises "from a relationship of trust and confidence *between parties to a transaction*") (emphasis supplied). However broad or narrow a trader's duty might be to the other investors with whom he trades, that duty lies at the heart of §10(b) and has little to do with the central focus of the misappropriation theory — whether the trader breached a fiduciary duty to third parties who may not have bought or sold the security in question.

There is legitimate concern that insufficient protection is afforded to investors by §10(b) as interpreted by this Court in *Chiarella*, and thus the appeal of the misappropriation theory is understandable. There is, however, no evidence that §10(b) of the 1934 Act was ever intended to protect newspapers from their columnists, patients from their psychiatrists, spouses from each other, parents from their children, or state lotteries from their commissioners.[6] Until this Court's holding in *Chiarella*, there was thus little thought given to conditioning liability under § 10(b) on whether or not a trader or a trader's tipper breached a fiduciary duty to some third party having little or no connection with the trading transaction.[7]

[6] *See, e.g.*, *Carpenter*, 484 U.S. at 19 (newspaper columnist); *United States v. Willis*, 778 F. Supp. 269 (SDNY 1991) (psychiatrist); *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc) (spouse), *cert. denied*, 503 U.S. 1004 (1992); *United States v. Reed*, 601 F. Supp. 685 (SDNY) (son), *rev'd in part on other grounds*, 773 F.2d 477 (2d Cir. 1985); *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995) (lottery commissioner).

[7] Even former SEC Commissioner Charles Cox has acknowledged that the misappropriation theory can be seen as "merely a pretext for enforcing equal opportunity in information." Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 Ohio St. L. J. 353, 366 (1988). *See* Bainbridge, *supra* note 4, at 1198. In sentencing Respondent in the instant case, the trial court considered Respondent's duty to his law firm and client as secondary to the impact of his trading on investors. "By the way, and parenthetically, I reject your counsel's argument and his theory that this is not a typical insider trading case. Certainly Dorsey and Whitney were identified as the victims, but it is obvious when you look at where the dollars came from, and the dollars certainly came, that the victims from a pecuniary standpoint, were those who thought they were putting their options into a fair market when you weren't playing fair." *United States v. James Herman O'Hagan*, Crim. No. 4-92-219, Transcript of Sentencing at 28 (October 27, 1994). Respondent was found guilty of violating §10(b) under the misappropriation theory, but was sentenced to prison by a judge who, once the parameters of the misappropriation theory were met, viewed Respondent's actions under a theory much more akin to the parity of information theory rejected by this Court in *Chiarella*.

Moreover, the misappropriation theory also contradicts this Court's holding in *Santa Fe* on three separate grounds: the theory does not require "deception" as defined in *Santa Fe;* misappropriation under the theory need not be "in connection with" the purchase or sale of a security; and breach of fiduciary duty lies at the heart of the claim.

First, this Court held in *Santa Fe* that there must be a "material misrepresentation or material failure to disclose," for conduct to be "deception" as that term is used in §10(b). *Santa Fe*, 430 U.S. at 474 (citations omitted) (emphasis added).[8] Under *Chiarella,* Respondent had no duty to disclose information, since this Court rejected the view that mere possession of material nonpublic information, without more, gives rise to a duty to disclose. *Chiarella*, 445 U.S. at 235. Respondent appropriated information belonging to his employer's client for Respondent's own use. This is no more a "deception" for purposes of §10(b), however, than is any other conversion of property (for example, if Respondent had

[8] As pointed out by the Fourth Circuit in *United States v. Bryan* 58 F.2d at 949 n. 16, the misappropriation theory puts the materiality requirement under section 10(b) entirely out of context. Although the misappropriated information may be important to the employer, materiality is judged from the prospective of an investor, making materiality irrelevant if the employer is not an investor.

used his telephone at work to call his broker long distance without reimbursing his employer). The misappropriation theory thus does not comport with this Court's holding that a claim of fiduciary breach in a complaint "states a cause of action under any part of rule 10b-5 only if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute." *Santa Fe*, 430 U.S. at 473-74.

Second, Respondent's alleged misappropriation furthermore was not "in connection with" the purchase or sale of a security.[9] The most natural reading of this statutory language covers manipulation of a securities market or attempts to deceive a participant in securities markets. Respondent's conduct fits neither category; if anyone was deceived, it was his employer and the employer's clients, not a person who purchased or sold securities when Respondent did. This straightforward reading of the "in connection with" requirement comports with Congress's purpose in enacting the statute, which was to protect the integrity of securities markets, not to create a property right to information.

Third, because a trader is liable if he was in a relationship of trust and confidence with a third party and is not liable if he had no such relationship, fiduciary duty, not manipulation or deception, lies at the core of liability.

[9] *See* Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA.L.REV. 179, 195 (1991) ("The Court [in *Blue Chip Stamps*] restricted the class of actionable claims under 10b-5 to those in which the fraud resulted in the purchase or sale of stock to the victim...[T]his connection between the fraud and the securities transaction has been completely eviscerated in cases applying the misappropriation theory.").

"Bootstrapping" the argument by characterizing the breach of fiduciary duty as itself being manipulation or deception does not change the fundamental character of the inquiry and does not bring the misappropriation theory any closer to the definition of "deception" under §10(b) set forth by this Court in *Santa Fe*.[10]

The misappropriation theory thus has logical consequences that go far beyond the meaning of the statute. Indeed, in the only case in which the misappropriation theory was squarely presented to this Court, only four of eight justices, without stating why, supported affirmance of securities law convictions. *Carpenter v. United States*, 484 U.S. 19, 24 (1987).

B. Congress has taken no action since 1934 that should cause this Court to alter its interpretation of Section 10(b).

1. Congress's intent in 1984 and 1988 with respect to the misappropriation theory is ambiguous.

In 1984, Congress enacted the Insider Trading Sanctions Act of 1984 (the "1984 Act") which, among other things, made it illegal to trade options and other derivative securities in circumstances where it would be illegal to trade in the underlying security. Insider Trading Sanctions Act

[10] Petitioner's Petition for Writ of Certiorari, at 11, states that "[a] person who misappropriates information in breach of a fiduciary duty necessarily commits deception." The same, however, could be said of any breach of fiduciary duty not accompanied by disclosure of the breach to the injured party. For further discussion applying *Santa Fe* to insider trading, *see* Bainbridge, *supra* note 4, at 1257-61.

of 1984, Pub. L. No. 98-376, 98 Stat. 1264, 1265 (codified in scattered sections of 15 U.S.C.). The loophole closed by this provision is obvious — a corporate insider or her tippee should not be allowed to circumvent §10(b) by trading in options instead of the underlying security. This provision shows that Congress was aware of the limited reach of §10(b), which some courts had held not to extend to trades with options dealers to whom an insider owes no fiduciary duty. *See Laventhall v. General Dynamics Corp.*, 704 F.2d 407, 411-12 (8th Cir. 1983), *cert. denied*, 464 U.S. 846 (1983). The 1984 Act also shows that Congress knew how to expand the reach of the 1934 Act insider trading prohibition when it wanted to.[11]

In the Insider Trading and Securities Fraud Enforcement Act of 1988, Congress enacted Section 20A of the 1934 Act providing a remedy for contemporaneous traders against "any person who violates any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information." Nowhere does the language of Section 20A expand the scope of prohibited conduct under the 1934 Act to include misappropriation of information for trading in the securities markets, despite the fact that Congress was aware

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[11] Amici in support of Petitioner instead interpret this amendment to have "generalized the misappropriation theory" under §10(b) because "corporations and their insiders do not owe fiduciary duties to those who own or trade options on corporate securities when those options are issued by others." NASAA Brief at 17. This interpretation reads far more into Congress's intent than is evident from the text of the statute, and indeed this amendment could just as well show that Congress was aware that §10(b) generally did not reach trading with persons to whom one owes no duty to disclose.

that this Court had apparently split 4-4 on the validity of the misappropriation theory in *Carpenter*. The first paragraph of Section 20A does not even mention "possession of *misappropriated* material, nonpublic information," the least a Congress eager to endorse the misappropriation theory might have done to show with which side of an evenly divided Supreme Court it agreed.

As Petitioner correctly points out, the legislative history indicates that Congress in 1988 sought to expand insider trading liability beyond the "classical theory" (extending the prohibition only to corporate insiders, corporate agents and their tippees), and that some members of Congress recognized the misappropriation theory as one means by which courts had accomplished that end. The House Committee on Energy and Commerce ("House Committee"), even in endorsing the misappropriation theory, nonetheless recognized this to be an unsettled area of the law: "The Court's opinion [in *Carpenter*] contained no discussion of the [misappropriation theory]. Thus, the misappropriation theory clearly remains valid in the Second Circuit . . . but is unresolved nationally." *Insider Trading and Securities Enforcement Act of 1988*, H.R. Rep. No. 910, 100th Cong., 2d Sess. 10 (1988). Although the Committee believed that "this type of security fraud should be encompassed within Section 10(b) and Rule 10b-5," *id.*, Congress did not act to include this or any other definition of illegal trading on the basis of material nonpublic information in the language of Section 10(b), despite the fact that some members of Congress recognized that a definition was needed. For example, Senator D'Amato, in introducing the Insider Trading Proscriptions Act of 1987, observed that:

> the present state of uncertainty about the law is simply not acceptable. The ambiguities about the law were vividly demonstrated in subcommittee hearings earlier where members of the securities industry and securities bar could not specify what conduct constituted insider trading and what conduct is permissible. I believe that an 'I know it when I see it standard' is totally unacceptable.

Statement of Alfonse D'Amato, Statements on Introduced Bills and Joint Resolutions, 100th Cong., 1st Sess., June 17, 1987, 133 *Cong. Rec.* S 8252. The one thing that is clear with respect to Congress's actions in 1988 is that Congress ultimately decided to leave §10(b) alone.

Finally, the remedy enacted in 1988 is unconnected with the misappropriation theory. It is contemporaneous traders, not third parties alleging "misappropriation" of their confidential information, who are entitled to sue under Section 20A. Disjuncture between the misappropriation theory and Congress's objective of protecting investors has thus caused a glaring incongruence between the remedy given to market participants in 1988 and the misappropriation theory's definition of the violation creating that remedy (a definition not only remarkable in its vagueness, but having little connection with the contemporaneous trader empowered to sue for the alleged harm).

2. *This Court should not look to the intent of subsequent Congresses to interpret Section 10(b) because that section has not been reenacted or amended since 1934.*

"When the text of §10(b) does not resolve a particular issue, we attempt to infer 'how the 1934 Congress would

have addressed the issue . . . .'" *Central Bank*, 114 S. Ct. at 1448, quoting *Musick, Peeler & Garrett v. Employers Insurance of Wausau*, 508 U.S. 286, 292 (1993). Both the Petitioner and the NASAA amici in support of Petitioner, however, instead focus on the intent of the 1984 and the 1988 Congresses, and in particular on the "findings" at the beginning of the 1988 legislation enacting section 20A of the 1934 Act.[12] Although these findings suggest that Congress endorsed an expanded vision of the §10(b) insider trading prohibition in 1988 (after Respondent traded), nowhere does the statutory language specify how expansive Congress believed the insider trading prohibition under §10(b) to be. Most important, nowhere does the statutory language enacted by Congress in 1984 or 1988 purport to amend §10(b). Congress knows how to amend a statute, and also knows that expressing its approval of administrative enforcement actions under the prior statute in "findings" at the beginning of a new statute simply does not do the trick.

Two doctrines — the "reenactment doctrine" and the even more speculative "acquiescence doctrine" — might still make the work of the Congresses of 1984 and 1988 relevant to interpreting this statute enacted in 1934. Both of these doctrines, however, were discussed extensively in *Central Bank's* interpretation of §10(b) and were disregarded. With respect to the reenactment doctrine, this Court observed:

> "When Congress reenacts statutory language that has been given a consistent judicial construction,

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[12] Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, §2, 102 Stat. 4677 (1988) (appended to 15 U.S.C. §78u-1 (1994)), quoted in NASAA Brief at 20-21.

> we often adhere to that construction in interpreting the reenacted statutory language. [citations omitted] Congress has not reenacted the language of §10(b) since 1934, however, so we need not determine whether the other conditions for applying the reenactment doctrine are present. Cf. *Fogerty v. Fantasy, Inc.*, [114 S.Ct. 1023, 1030-1033] (1994).

Central Bank, 114 S.Ct. at 1452.[13] Neither can the misappropriation theory garner much further support from applying the "acquiescence doctrine" to the 1984 and 1988 amendments to the 1934 Act. The respondents in *Central Bank* argued that "Congress has amended the securities laws on various occasions since [courts began to adopt the interpretation that respondent's favored, and] from that, respondents infer that these Congresses, by silence, have acquiesced in the judicial interpretation of §10(b)." *Id.* at 1452. This Court rejected that argument, noting that this Court had reserved the issue of aiding and abetting on two previous occasions. This Court went on to observe that such an "acquiescence doctrine" has its limitations because "Congressional inaction cannot amend a duly enacted statute." *Id.*. at 1453, quoting *Patterson v. McLean Credit Union*, 491 U.S. 164, 175 n. 1 (1989).

Furthermore, in *Central Bank*, this Court specifically rejected reliance on references to aiding and abetting liability in the 1983 and 1988 committee reports and reiterated that

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13 "At least insofar as the re-enactment doctrine applies to cases arising under Rule 10b-5, however, *Central Bank* places it in serious jeopardy." Bainbridge, *supra* note 4, at 1205.

"[w]e have observed on more than one occasion that the interpretation given by one Congress (or a committee or Member thereof) to an earlier statute, is of little assistance in discerning the meaning of that statute." *Id.* at 1452, quoting *Public Employees Retirement System v. Betts*, 492 U.S. 158, 168 (1989); and citing *Weinberger v. Rossi*, 456 U.S. 25, 35 (1982); *Consumer Product Safety Comm'n v. GTE Sylvania, Inc.*, 447 U.S. 102, 118 n. 13 (1980).

This Court thus declined to apply either the reenactment doctrine or the acquiescence doctrine to §10(b) and concluded its discussion by stating in no uncertain terms that "[w]e find our role limited when the issue is the scope of conduct prohibited by the statute. [citation omitted]. That issue is our concern here, and we adhere to the statutory text in resolving it." *Central Bank*, 114 S.Ct. at 1453. This Court cannot, consistent with *Central Bank*, give substantial weight to the intent of the Congresses of 1984 and 1988 concerning § 10(b) of the 1934 Act.

II. Because the Misappropriation Theory is Inconsistent with this Court's Prior Interpretation of the 1934 Act, Lower Courts Have Applied the Theory Inconsistently, Leading to an Intolerably Vague Standard for Criminal Liability

A. The case law under the misappropriation theory is vague.

In *Chiarella*, this Court rejected the parity of information theory under which "the use by anyone of material information not generally available is fraudulent because such information gives buyers or sellers an unfair advantage over less informed buyers and sellers." *Chiarella*, 445 U.S. at 231. This theory imposed on all persons in possession of material nonpublic information a duty to disclose or abstain from trading. The duty was presumed to extend from traders to other market participants and would not have conditioned liability on breach of a fiduciary duty to some third party who may or may not have been a market participant.

The parity of information theory was rejected by this Court in *Chiarella* on the grounds that neither the language of §10(b) nor the legislative history evidenced a Congressional intent to create such a rule. *Id.* at 233. Moreover, this Court expressed concern that such a holding "would raise questions whether criminal or civil defendants would be given fair notice that they have engaged in illegal activity." *Id.* at 235 n.20 (citing *Grayned v. City of Rockford*, 408 U.S. 104, 108-09 (1972)).

Since *Chiarella*, various interpretations of the misappropriation theory have been articulated by district and appellate courts, each reaching a narrower range of conduct than the parity of information theory. However, this more "targeted" approach to insider trading liability has a price that may be inevitable when legal proscriptions are enacted by courts rather than by Congress: each court interpreting the theory has envisioned a target of different size and shape, making the misappropriation theory intolerably vague. The possibility of fines, penalties, lost careers and even jail terms rests on an uncertain articulation of which parties have a duty to refrain from trading while in possession of material nonpublic information.[14] This vagueness is compounded by

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[14] *See* Edward Brodsky, *Insider Trading: The Misappropriation Theory,* N.Y.L.J., Nov. 13, 1996 (arguing that the case-by-case

the fact that the target -- or rather moving target -- fixed in the sights of courts using the misappropriation theory is breach of fiduciary duty owed to an entrustor of confidential information, a concern having little to do with manipulative or deceptive conduct defrauding participants in the securities markets. Rather than urge Congress to respond to *Chiarella* by amending the 1934 Act to adopt an investor protection - based philosophy such as the parity of information theory, the Commission has urged courts, by expanding upon Chief Justice Burger's dissenting opinion in *Chiarella*, to take uncoordinated aim at a new doctrinal target having little relation to the purposes for which the statute was enacted.

Examples (both real and hypothetical) of the inconsistency generated by the misappropriation theory are plentiful:

1) A psychiatrist buys or sells shares of BankAmerica Corporation after learning from a patient, the wife of the president of American Express, that her husband is seeking to become CEO of BankAmerica; *or* 2) the same facts as above, but the wife passes the inside information to her hairdresser, rather than her psychiatrist.[15]

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evolution of the misappropriation theory has led to confusion in an area where, given the possibility of criminal sanctions, certainty is needed); Elkan Abramawitz, *Insider Trading: Another Chance for Clarity*, N.Y.L.J., Nov. 5, 1996 (noting that the current unpredictability regarding the scope of the misappropriation theory "creates a fundamental unfairness to defendants who lack adequate notice of the legality and consequences of their actions").

[15] *See United States v. Willis*, 778 F. Supp. 269 (S.D.N.Y. 1991) in which the court sustained the psychiatrist's conviction for insider trading based on the breach of the fiduciary duty owed by a psychiatrist to a patient. The hairdresser example was taken from John R. Beeson, Com-

3) A corporate CFO confesses to a priest that she has been manipulating the books of her company to increase earnings. The priest absolves the penitent of her sins and calls his broker to place a sell order; *or* 4) the same facts as above, but the CFO confesses her fraudulent conduct to a fellow parishioner from whom she seeks advice on whether to turn herself in. The fellow parishioner promises divine forgiveness and calls his broker.[16]

5) The author of the "Heard on the Street" column in the *Wall Street Journal* trades on information learned in connection with research conducted for the column, in violation of a policy of his employer, Dow Jones, Inc., prohibiting such trading; *or* 6) the same facts as above, but Dow Jones, Inc. authorizes the author of the "Heard on the Street" column to trade on recommendations that he intends to make the next day.[17]

ment, *Rounding the Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory*, 144 U. Pa. L. Rev. 1077, 1137 (1996). Presumably no insider trading liability would attach to the hairdresser's trades, as the relationship between client and hairdresser does not give rise to a fiduciary duty under state law.

16 Following the logic of *Willis*, the priest is arguably guilty of insider trading under the misappropriation theory based on a breach of the relationship of trust and confidence owed by a priest to a parishioner. Application of the misappropriation theory to the second situation, however, might require a court to delve into whether the person to whom the confession was made had a duty under applicable church doctrine not to disclose or use the information.

17 The first example sets forth the facts of *Carpenter v. United States*, 484 U.S. 19 (1987). In the second example, the trades are presumably legal.

7) Father, a board member of ABC Corporation, often discloses confidential information about ABC Corporation to his son. Relying on such confidential information, the son purchases ABC call options; *or* 8) Wife, whose family founded and still controls ABC Corporation, tells her husband that the family has agreed to sell the business to an acquiror at a substantial premium over current market value. The next day, Husband instructs his broker to purchase shares of ABC Corporation.[18]

The differing results in the above examples highlight a serious shortcoming of the misappropriation theory: insider trading liability turns not on effects on the marketplace or on potential damage to selling or purchasing shareholders, but rather on a duty owed to the *source* of the information, regardless of whether that source is a buyer or seller of securities or even a market participant at all. Even worse, because the duty to that source arises from a fiduciary or "similar relationship of trust and confidence," the scope of that duty may be defined by state law, by private agreement (as in the *Wall Street Journal* case) or by the inherent nature of some other relationship (as in the parishioner, psychiatrist

18 The facts of the father/son example are based on *United States v. Reed*, 601 F.Supp. 685 (S.D.N.Y.), *rev'd. on other grounds*, 773 F.2d 477 (2d Cir. 1985), in which an allegation that the son breached a fiduciary duty to his father by trading on confidential information withstood a motion to dismiss. The court noted that the father and son frequently discussed business issues, thus giving rise to the equivalent of a fiduciary relationship. *Id.* at 690 n.6. The husband/wife example is derived from the facts of *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc), in which the court held that no fiduciary or similar relationship of trust and confidence existed between the husband and wife so as to give rise under the misappropriation theory to liability of the husband's stockbroker as a "tippee."

and family relationship examples). This is problematic because the scope of fiduciary duties outside the traditional corporate insider context is far from clear, particularly when courts are asked to consider which relationships, although not fiduciary in the traditional sense, nonetheless constitute a "similar relationship of trust and confidence."[19] Indeed, this lack of clarity raises concerns of constitutional proportion in the criminal context. *Chestman*, 947 F.2d at 570 ("Useful as such an elastic and expedient definition of confidential relations, i.e., relations of trust and confidence, may be in the civil context, it has no place in the criminal law").

The attorney/client relationship provides a good illustration of the ambiguity which surrounds the scope of fiduciary duties outside the traditional corporate insider context. Respondent's conduct does not unequivocally run afoul of the ALI's position that trading on confidential client information is prohibited when "there is a substantial likelihood that doing so will adversely affect a material interest of the client or if the client has directed that the lawyer not use [the information]." Draft Restatement (Third) of the Law Governing Lawyers §111(1).[20]

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[19] *See, e.g. Chestman*, 947 F.2d at 567 ("[A] fraud-on-the-source theory of liability extends the focus of Rule 10b-5 beyond the confined sphere of fiduciary/shareholder relations to fiduciary breaches of any sort, a particularly broad expansion of 10b-5 liability if the add-on, a 'similar relationship of trust and confidence,' is construed liberally").

[20] Trading by the acquiror's attorney in stock of a target, particularly in large quantities, could harm the client tender offeror by putting upward pressure on the price of the target company stock. On the other hand, the lawyer's purchases could help the client by putting more stock in friendly hands. *See* Stephen M. Bainbridge, *Insider Trading Under*

Adoption of the misappropriation theory will thus require the federal courts to embroil themselves not only in this debate over the fiduciary duties of lawyers to their clients, but in similar debates over the fiduciary duties of accountants, appraisers, and investment bankers to their clients; doctors to their patients; taxi and limousine drivers to their passengers; newspaper columnists to their employers and their readers; professors to their students who work for law firms; priests, ministers and rabbis to their parishioners; and so on. In each case, a federal court will have to analyze the particular relationship to determine whether a "relationship of trust and confidence" existed sufficient to send one of the parties to jail for misappropriation of information entrusted to him by the other.

B. *The misappropriation theory is intolerably vague as a standard for criminal liability.*

The common-law development of criminal standards through the misappropriation theory furthermore implicates due process considerations previously articulated by this Court. This Court has repeatedly recognized, for example, that a statute prescribing criminal punishment must provide a definite standard of guilt. *See, e.g., Screws v. United States*, 325 U.S. 91 (1945); *United States v. Kozminski*, 487 U.S. 931 (1988); *Grayned v. City of Rockford*, 408 U.S. 104

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the Restatement of the Law Governing Lawyers, 19 J.Corp.L. 1 (1993). Although Professor Bainbridge has urged the ALI to adopt a more definitive ban on trading by a lawyer on confidential client information, the drafters of the Restatement so far have not done so.

(1972); *Chiarella*, 445 U.S. at 235.[21] As pointed out above, the misappropriation theory is extraordinarily vague and would probably be unconstitutionally vague as applied to at least some criminal defendants.

III. Defining the Scope of the Misappropriation Theory Will be Problematic.

If, irrespective of the arguments developed above, this Court finds that the language of § 10(b) encompasses the misappropriation theory, this Court will need to define the

[21] In *United States v. Wiltberger*, 18 U.S. 76 (1820), Chief Justice Marshall articulated three principles to guide courts in the judicial construction of criminal statutes. First, he observed that the legislature, not the judiciary, should define crimes and establish punishments for their violation. *Id.* at 95 For example, in *United States v. Kozminski*, 487 U.S. 931 (1988), this Court noted that "[i]t is one thing to recognize that some degree of uncertainty exists whenever judges and juries are called upon to apply substantive standards established by Congress; it would be quite another thing to tolerate the arbitrariness and unfairness of a legal system in which judges would develop the standards for imposing criminal punishment on a case-by-case basis." *Id.* at 951. Justice Marshall's second principle, the "rule of lenity," dictates that ambiguity concerning the scope of a criminal statute be resolved in favor of the defendant. *Wiltberger*, 18 U.S. at 96. *See also United States v. Granderson*, 114 S.Ct. 1259, 1267 (1994) ("where text, structure, and history fail to establish that the Government's position is unambiguously correct -- we apply the rule of lenity and resolve the ambiguity in [defendant's] favor"); *United States v. Thompson/Center Arms Co.*, 504 U.S. 505, 517-18 (1992) (invoking the rule of lenity to resolve an ambiguity in a tax statute). Chief Justice Marshall's third canon of judicial construction of criminal statutes holds that criminal statutes must be strictly construed. *Wiltberger*, 18 U.S. at 95-96; *Commissioner v. Acker*, 361 U.S. 87, 91 (1959). "[T]o determine that a case is within the intention of the statute, it's language must authorize us to say so." *Wiltberger*, 18 U.S. at 95-96.

scope of the underlying relationship of trust and confidence giving rise to a duty to disclose material nonpublic information. There are two approaches this Court could take: either develop a federal common law of fiduciary duty, or condition liability on the defendant's breach of state fiduciary duty law.[22] *See* Bainbridge, *supra* note 4 at 1206.

Developing a federal common law of fiduciary duty would be the simplest approach to defining the necessary confidential relationship. A number of courts adopting the misappropriation theory have relied upon the provisions of the Restatement (Second) of Agency ("Restatement") concerning a fiduciary's use of confidential information.[23] This Court may find, however, that this definition is not complete for purposes of federal securities law, as the Restatement is focused on potential competition with or injury to the principal, not on potential injuries to investors

[22] Courts adopting the misappropriation theory seem to be creating a federal common-law of confidential relationships without explicitly addressing the choice-of-law issue. *See, e.g.*, *Chestman*, 947 F.2d at 570 (marriage, without more, is not a fiduciary relationship; no discussion of choice of law); *Willis*, 778 F. Supp. at 209 (a psychiatrist-patient relationship is a fiduciary relationship; no discussion of choice of law); *SEC v. Singer*, 786 F. Supp. 1158, 1169-70 (S.D.N.Y. 1992) (holding that an attorney is a fiduciary to his client without relying on state regulation of lawyers or federal common law).

[23] *See, e.g.*, *Chestman*, 947 F.2d at 569; *SEC v. Cherif*, 933 F.2d 403, 411 (7th Cir. 1991), *cert. denied*, 502 U.S. 1071 (1992); *SEC v. Materia*, 745 F.2d 197, 202 n.4 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985). Section 395 of the Restatement (Second) of Agency prohibits agents from using or communicating confidential information of the principal "in competition with or to the injury of the principal," even if such information does not relate to the transaction in which he is then employed. RESTATEMENT (SECOND) of AGENCY, § 395 (1958).

with whom the agent trades. Thus, this concept would presumably reach purchases of a would-be tender offeror's target stock by a lawyer or accountant of the tender offeror, since the principal (tender offeror) could be injured by such an action. It might not reach a *Chiarella*-type situation, however, depending on how broadly the concept of "injuring the principal" is construed, and indeed on who the principal is understood to be, nor would it necessarily reach a judge's law clerk who traded on information contained in an opinion that had not yet been issued, or a Federal Reserve Bank employee who trades with knowledge of an imminent change in the margin rate.[24] Thus, even in relying on the Restatement, this Court would still need to grapple with key definitional issues, including how broadly to construe the concept of "injuring the principal," and what connection the investment transaction ought to have to the fiduciary relationship.

Instead of developing a federal common law of fiduciary duty, this Court could incorporate state law fiduciary duty concepts into its rule of decision. Under that approach, the content of the federal insider trading prohibition would vary depending on which state's law controls. *See* Bainbridge, *supra* note 4, at 1206. Incorporating state law fiduciary duty concepts as the lynchpin of a federal securities claim of insider trading thus potentially leads to different results on

[24] *See* American Law Institute, FEDERAL SECURITIES CODE, § 1603, cmt. d (1980) (suggesting a category of "quasi-insider" be developed to bring these types of traders within the ambit of prohibited trading on material nonpublic information).

similar facts in different states.[25] While this may be an acceptable outcome on principles of federalism where a state-law question is concerned, it is much less acceptable in interpreting the federal securities statutes, where a uniform interpretation best effectuates federal policies of predictability, judicial economy and investor protection. *Cf. Lampf, Pleva, Lipkind, Prupis & Pettigrow v. Gilbertson et al.*, 501 U.S. 350, 357 (1991).

Moreover, under either approach the misappropriation theory would take §10(b) jurisprudence precisely where this Court said it should not go: into the terrain of fiduciary duty law. *See Santa Fe*, 430 U.S. at 472. By conditioning breach of §10(b) on an underlying breach of a fiduciary duty, this jurisprudence requires the federal courts to decide

[25] One need only look at the different states' views on the fiduciary character of a marriage to understand how fractured the securities law would become if this Court determined that incorporation of state law was the proper approach. While the Second Circuit held that marriage *per se* does not give rise to a fiduciary relationship in New York, *Chestman*, 947 F.2d at 571, other courts disagree, but also cannot agree among themselves as to when the fiduciary relationship begins and ends. *See DeLorean v. DeLorean*, 511 A.2d 1257 (N.J. Super. 1986) (married persons owe each other fiduciary duties); *In re: Marriage of Sokolowski*, 597 N.E.2d 675 (Ill. App. 1992) (confidential relationship begins at engagement); *Harroff v. Harroff*, 398 S.E.2d 340 (N.C. App. 1990) (fiduciary duties still owed during negotiation of a separation agreement). *In re: Marriage of Auble*, 866 P.2d 1239 (Or. App. 1994) (no such duties owed by persons ending their marriage). Indeed, given the variations among state court decisions on this issue, liability for trading on material non-public information would vary depending on whether one was unofficially engaged, officially engaged, married, happily married, negotiating a separation agreement, separated or divorced, and may even depend on whether confidential information was disclosed at a couple's New York apartment or New Jersey country home.

when a fiduciary duty exists and when that duty has been breached. Yet this Court in *Santa Fe* eschewed that role for the federal courts applying federal securities law, both because the language of §10(b) and Rule 10b-5 does not permit encompassing breaches of fiduciary duty separate from deceptive conduct in a securities transaction, *id.*, and because of federalism concerns. *Id.* at 478. Those same rationales ought to be determinative here.

IV. Congress Needs to Enact a Law Defining Illegal Trading On Material Nonpublic Information.

Ultimately, it is up to Congress to define the parameters of illegal trading, and the necessary connection between a trading transaction and any third-party fiduciary relationship. Indeed, over the last ten years, as the Commission has begun more vigorously to enforce insider trading prohibitions, including by criminal referral, and as the penalties for such trading have been enhanced, many people have called on Congress to specify when trading on material nonpublic information is illegal, so far without success.

In spite of its reluctance to act, Congress is the best institution to make these determinations, and there are several approaches it could take. Congress could establish a *pre-Chiarella* parity-of-information approach, even for outsiders, and then carve out exceptions for securities analysts, and perhaps others in possession of material nonpublic information. Congress could develop a statutory definition of the proscribed conduct based on a theory of property rights in information, and clearly define the relationship between the property rights in information and the trading transaction necessary to give rise to liability. In addition, Congress could bifurcate criminal liability from

civil liability and SEC enforcement actions, in order to allow broader liability in the civil context and yet define clear, very specific standards for the imposition of criminal sanctions. Finally, Congress could adopt the insider trading provisions of the Federal Securities Code, developed with great care over ten years by the American Law Institute under the guidance of Professor Louis Loss.[26] Absent such a determination by Congress, though, this Court ought not itself legislate the proper policy approach to trading on material nonpublic information.

We condemn the alleged conduct at the core of this case — a lawyer's use of confidential client information to trade in the stock market. Trading while in possession of material nonpublic information can "cheat" honest market participants out of an even playing field, just as cheating on examinations cheats honest students out of a fair chance to demonstrate their knowledge and ability. However, those of us who are law professors recognize that it would be perilous to seek the expulsion of a student for conduct not coming squarely within the proscriptions of a school's honor code. Indeed, we recognize that the absence of a clearly defined honor code may encourage cheating. Similarly, Congress needs to do what the courts and the Commission at this point cannot — assure the integrity of our securities markets by specifying when it is illegal to trade while in possession of material nonpublic information or by giving the Commission the authority to do the same.

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[26] *See* American Law Institute, FEDERAL SECURITIES CODE, § § 1602, 1603 (1980).

The misappropriation theory is appealing precisely because it comports with our collective sense of moral approbation of people breaching a position of trust for their personal, financial advantage. What it does not do however, is comport with the fundamental policy concerns of Congress in enacting the 1934 Act: investor protection and the integrity of the market. An investor who has paid too much for stock or sold it for too little in a transaction with a person in possession of material nonpublic information suffers loss irrespective of whether the counterparty breached a fiduciary duty to a third party. Conditioning liability on the counterparty's relationship with the third party introduces state fiduciary duty law into the heart of federal insider trading regulation. If Congress believes that the 1934 Act as interpreted by this Court in *Chiarella* does not adequately protect such investors, the Act should be amended.

Conclusion

For the foregoing reasons, amici respectfully request this Court to affirm the holding below.

Respectfully submitted,

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