NOTE

United States v. O'Hagan: Defining the Limits of Fraud and Deceptive Pretext Under Rule 10b-5

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I. INTRODUCTION

Imagine you had information regarding the results of a horse race before the race was even run. More than a gambler's dream, the trading of stocks based upon inside information1 is a phenomenon which is real and, by some accounts, pervasive.2 For numerous reasons, insider trading is considered problematic.3 In particular,

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1. See United States v. Mylett, 97 F.3d 663, 666 (2d Cir. 1996) (defining inside information as "material nonpublic information").
Congress has acknowledged insider trading to be problematic in terms of the unfairness it creates in the securities markets. In response to this unfairness, Congress promulgated a broad sanction regime. Part of this sanction regime is the misappropriation theory of criminal liability arising under Securities and Exchange Commission (SEC) Rule


5. See 15 U.S.C. § 78j (1994) [hereinafter § 10(b)]. This section states, in part:

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national exchange, . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

See also 15 U.S.C. § 78p (1994) [hereinafter § 16(b)]. Section 78p states:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months.

See generally Nicholas L. Georgakopoulos, Insider Trading as a Transactional Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation, 26 CONN. L. REV. 1 (1993). Georgakopoulos provides an excellent overview of § 10(b) and the various theories of Rule 10b-5 liability. See also Donald C. Cook & Myer Feldman, Insider Trading under the Securities Exchange Act, 66 HARV. L. REV. 385 (1953). Despite the age of this article, the authors, both past members of the Securities and Exchange Commission, provide an excellent overview of how § 16(b) functions.
10b-5. This Note argues that broadening the present embezzlement model of the Rule 10b-5 misappropriation theory will more fully reflect both the language and intent of § 10(b) (of the 1934 Securities Exchange Act) and Rule 10b-5, and more importantly accommodate the sophistication of today's insider trading schemes. Part II of this Note examines the uses of inside information both prior to and after the creation of the 1934 Securities Exchange Act, and how § 10(b) and Rule 10b-5 were created to proscribe these uses. Part III examines the language and intent behind § 10(b) and Rule 10b-5 and argues that their language and intent legitimates a broader sanction regime which is necessary to combat the present sophistication of insider trading. Part IV examines the criticisms of the present embezzlement model of the Rule 10b-5 misappropriation theory as expressed by Justices Scalia and Thomas, and shows how a broader form of criminal liability is necessary despite these criticisms.

II. THE HISTORY OF THE RULE 10B-5
MISAPPROPRIATION MODEL

While § 10(b) and Rule 10b-5 arose as a part of the 1934 Securities Exchange Act and from the SEC's regulative power respectively, the misappropriation theory of Rule 10b-5 arose as a product of case law.

The sanction regime of § 10(b) and Rule 10b-5 arose as a response to massive investor losses before and shortly after the stock market crash of 1929. After the crash, stock exchanges, particularly the New York Stock Exchange, and the public were clamoring for a new law that would impose criminal sanctions for securities fraud.

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6. 17 C.F.R. § 240.10b-5 (1997) [hereinafter Rule 10b-5]. This rule states:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   (a) To employ any device, scheme, or artifice to defraud,
   (b) To make any statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
   (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
   in connection with the purchase or sale of any security.


8. The lack of congressional or SEC codification of the misappropriation theory has generated criticisms of this model. These criticisms will be examined in Part II.

9. See S. REP. NO. 73-47, at 2 (1933) ("Those who have considered the matter place ... losses in this country at $1,700,000,000 annually even before the depression."); H.R. REP. NO. 73-85, at 2 (1933) ("Fully half or $25,000,000,000 worth of securities floated during this period (post-World War I) have been proved to be worthless."). See generally 77 CONG. REC. 2930
York Stock Exchange, made attempts at self-regulation.\textsuperscript{10} Specifically, the exchanges attempted to regulate fraud perpetrated on investors.\textsuperscript{11} These attempts at self-regulation, however, failed,\textsuperscript{12} prompting Congress to begin a series of widely supported\textsuperscript{13} investigations into stock market practices.\textsuperscript{14}

These congressional investigations revealed that inside information was a vehicle by which fraud was perpetrated on investors. For example, inside information allowed for the creation of stock pools.\textsuperscript{15} Stock pools were considered fraudulent in that pools induced investors outside the pools to invest through the creation of fictitious activity.\textsuperscript{16} The Senate received testimony regarding the creation of a pool to manipulate RCA stock.\textsuperscript{17} The members of the pool were the president of RCA, his wife, the president of M.J. Meehan & Co. (a brokerage firm), his wife, and a number of others.\textsuperscript{18} The members of the pool sought to manipulate the price of RCA stock though the
creation of massive short-term volatility.\(^{19}\) In one week the pool made $4,924,073.27.\(^{20}\)

Congress created § 16(b) in response to pools and other forms of fraudulent activities.\(^{21}\) Section 16(b) made it illegal for a beneficial owner (one who owns or is the beneficiary of at least ten percent of a corporation’s stock), a director, or an officer of a corporation to buy or sell the securities of any issuing corporation with which they have one of the aforementioned relationships within a six-month period.\(^{22}\) While § 16(b) covered individuals such as the president of RCA, it failed to cover individuals such as the wife of the president of RCA and other persons.\(^{23}\) Criminal liability for these outsiders was created in the form of Rule 10b-5 via the SEC’s § 10(b) enforcement power.\(^{24}\)

In short, Rule 10b-5 acted to fill the gaps in § 16(b).

In 1942 the SEC promulgated Rule 10b-5\(^{25}\) as a fraud catch-all.\(^{26}\) The catch-all nature of Rule 10b-5 is reflected in the SEC’s comments on the first application of Rule 10b-5: “These anti-fraud provisions are not intended as a specification of particular acts or practices which constitute fraud, but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others.”\(^{27}\) It is clear from the above passage that the SEC was concerned with advantage being taken of investors and others. It is the category of “others” and the creation of criminal liability for

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19. Id. In the course of one week, 1,493,400 shares of RCA stock were traded. Id.
20. Id.
22. See 78 CONG. REC. 11006-11007 (1934). See also Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582, 594-595 (1973) (outlining the “pragmatic test” for § 16(b) liability). See generally Kari Shumpei Okamoto, Oversimplification and the SEC’s Treatment of Derivative Securities Trading by Corporate Insiders, 1993 Wis. L. Rev. 1287, 1312. Okamoto argues that the present day expansion of § 16(b) liability to derivatives constitutes an overly broad application of § 16(b) which in fact harms some types of otherwise beneficial trading. Id.
23. See, e.g., Peter Helmoop Noyes, The Public Returns to Wall Street, THE NATION, May 31, 1933, at 616 (defining beneficiaries of inside information as “[d]irectors and officials of companies or their friends [who] profit from advance information before it becomes public.”).
24. See 15 U.S.C. § 78j (outlining the SEC’s enforcement power under § 10(b)).
25. See 17 C.F.R. § 240.10b-5.
26. See generally Chiarella v. United States, 445 U.S. 222, 235 (1980) (declining to find 10b-5 criminal liability for the employee of a print shop who used inside information gained in the course of printing documents to trade on securities.). See also James H. Schropp et al., Liability for Insider Trading Under the Federal Securities Laws, 525 P.L.I./CORP. 139, 262 (1986) (describing § 10(b) and Rule 10b-5 as a catch-all clause to enable the Commission “to deal with new manipulative [or cunning] devices” (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976)).
the purposes of protecting this category of persons which has created the most controversy regarding Rule 10b-5. 28

There are two theories of Rule 10b-5 criminal liability. 29 The traditional theory sanctions individuals who trade on inside information obtained in the course of a fiduciary relationship with shareholders. 30 There are two ways in which an outsider can have a fiduciary relationship with shareholders. 31 First, a fiduciary relationship can arise where an insider discloses information to an individual and the individual knows, or should have known, that the disclosure is a breach of a fiduciary duty. 32 This is known as "tippee liability." 33 An example of Rule 10b-5 tippee liability would be the case of the wife of the president of RCA, who would be liable in that she received inside information 34 from a fiduciary of the company (her husband, the president) and traded on this information. 35

Second, a fiduciary duty can arise where an outsider obtains access to confidential information via a fiduciary relationship with a company or its shareholders. 36 This is known as temporary insider liability. 37 Temporary insider liability can be illustrated by the case of an attorney who receives inside information in the course of her relationship with a corporate client and trades on this information. 38

The fraud in these examples arises from the fact that the wife via the husband, and the attorney via her employment relationship with

29. See generally United States v. Chestman, 947 F.2d 551, 564-567 (2d Cir. 1991) (declining to find Rule 10b-5 criminal misappropriation liability for a stockbroker who obtained inside information from a client).
30. Id. at 564.
31. Id. at 565.
32. Id.
33. Id. See also United States v. Ruggiero, 56 F.3d 647, 655 (5th Cir. 1995) (finding Rule 10b-5 insider liability for Ruggiero, an auditor for a company, and tippee liability for Ruggiero's codefendant Parker, to whom Ruggiero gave inside information).
34. While it is unclear whether knowledge of the creation of a stock pool by insiders would be considered inside information for the purposes of Rule 10b-5 liability, it is clear that such an argument is plausible. See, e.g., Mylett, 97 F.3d at 667 (finding that materiality is determined through "a balancing of both the indicated probability that the event will occur, and the anticipated magnitude of the event in light of the totality of the company activity") (quoting Basic Inc. v. Levinson, 485 U.S. 224, 238 (1988)).
35. See Ruggiero, 56 F.3d at 655. See generally Chestman, 947 F.2d at 567-570 (defining tippee liability arising in marital relations).
36. See Chestman, 947 F.2d at 565.
37. Id.
38. Chestman, 947 F.2d at 565.
the corporation, maintain the pretext of having a relationship of trust and confidence with the shareholders of a company.

The second theory of Rule 10b-5 criminal liability is the misappropriation theory. The misappropriation theory sanctions individuals who trade on inside information gained in the course of a fiduciary relationship with another party.\(^{39}\) Specifically, criminal liability under the misappropriation theory occurs when one willfully misappropriates material nonpublic information in breach of a fiduciary duty or similar relationship of trust and confidence, and uses that information in a securities transaction.\(^{40}\) Unlike the traditional theory, the misappropriation theory does not require a breach of fiduciary duty to a shareholder, but rather requires a breach of fiduciary duty to some party in the course of obtaining inside information.\(^{41}\) For example, in United States v. Willis,\(^{42}\) the district court refused to dismiss the indictment of a psychiatrist who traded on inside information obtained from a patient.\(^{43}\) The court found that the relationship between a treating psychiatrist and his patient is an inherently fiduciary relationship.\(^{44}\) Similarly, in United States v. Reed,\(^{45}\) the district court refused to dismiss the indictment of the son of an insider who obtained inside information from his father and proceeded to trade on this inside information.\(^{46}\) The court found that a fiduciary relationship existed where the defendant’s father expected the issues discussed between the father and son to remain confidential.\(^{47}\) In short, these cases illustrate that the source of inside information is irrelevant for the purposes of determining Rule 10b-5 criminal liability because criminal liability is ascertained by determining whether a fiduciary duty was breached during the course of obtaining inside information.

Congress has given tacit approval to the misappropriation theory.\(^{48}\) Apparent congressional approval of the misappropriation

\(^{39}\) Id. at 566.

\(^{40}\) Id.

\(^{41}\) See id.


\(^{43}\) Id. at 209.

\(^{44}\) Id.


\(^{46}\) Id. at 737.

\(^{47}\) Id. at 690.

\(^{48}\) See House Comm. on Energy and Commerce, Insider Trading and Securities Fraud Enforcement Act of 1988, H.R. Rep. No. 100-910, at 10 (1988), reprinted in 1988 U.S.C.C.A.N. 6043, 6047 ("[T]he misappropriation theory clearly remains valid in the Second Circuit . . . but is unresolved nationally. In the view of the Committee, however, this type of security fraud should be encompassed within Section 10(b), and Rule 10b-5.").
theory is expressed in Congress's rejection of attempts to reform Rule 10b-5 by creating more definite types of criminal liability. In particular, Congress has resisted attempts to define insider trading, a step that would limit the scope of the misappropriation theory by creating a bright-line rule as to what constitutes criminal liability for insider trading.

Congressional resistance to defining insider trading in part can be attributed to the increased sophistication of insider trading over the past fifteen years. For example, in 1986, Ivan Boesky paid a $150,000,000 penalty to the SEC for insider trading. Boesky engaged in an insider trading scheme whereby Boesky traded on inside information gained through companies he controlled. Congress responded to this increased sophistication by creating the Insider Trading and Securities Fraud Enforcement Act of 1988 (hereinafter I.T.S.F.E.A.). Among other things, the I.T.S.F.E.A. created

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(b)(1) It shall be unlawful for any person, directly or indirectly, to use material, non-public information to purchase or sell any security, by the use of any means or instrumentalities of interstate commerce, or of the mails, or of any facilities of any national securities exchange . . . if such person knows or is reckless in not knowing that such information has been obtained wrongfully, or if the purchase or sale of such security would constitute a wrongful use of such information . . . . [I]nformation shall have been used or obtained wrongfully only if it has been obtained by, or its use would constitute, directly, or indirectly, theft, conversion, misappropriation or a breach of any fiduciary, contractual, employment, personal, or other relationship of trust and confidence.


52. See Boesky, 1986 WL 152583, at *1.


54. See 15 U.S.C. § 78u-1(e) (1994). The statute creates a bounty system as follows: "[T]here shall be paid from amounts imposed as a penalty under this section and recovered by the Commission or the Attorney General, such sums, not to exceed 10 percent of such amounts . . . to the person or persons who provide information leading to the imposition of such penalty."
controlling person liability\textsuperscript{55} to stop insider trading schemes similar to the one employed by Boesky. The misappropriation theory met this ever increasing sophistication of insider trading by creating criminal liability for the breach of any fiduciary duty committed in the course of obtaining inside information. The creation of criminal liability for the breach of any fiduciary duty\textsuperscript{56} allows for broad sanction power. It is this same broad sanction power which has made the misappropriation theory a target of criticism.

While Congress has given its tacit approval to the misappropriation theory, prior to the Supreme Court's decision in \textit{United States v. O'Hagan}\textsuperscript{57} the federal courts were split on supporting the theory.\textsuperscript{58} The Second, Seventh, and Ninth Circuits supported the misappropriation theory, while the Fourth and Eighth Circuits declined to support it.\textsuperscript{59} \textit{United States v. Newman} illustrates the rationale of the circuits supporting the misappropriation theory.\textsuperscript{60} In \textit{Newman}, the Court held that a defendant could be criminally liable under 10b-5 for trading on inside information despite the fact that the defendant did not have a fiduciary relationship with a buyer or seller of securities.\textsuperscript{61} The court reasoned the Rule 10b-5 phrase "any person in connection with" permitted such criminal liability to accrue to persons who misappropriated inside information gained from any source regardless of whether that source was a buyer or seller of securities.\textsuperscript{62} The only caveat to this broad theory of criminal liability was that a defendant must have a fiduciary duty to the source of the inside information.\textsuperscript{63} In short, under the court's analysis in \textit{Newman}, the phrase "any person" meant that any person with a fiduciary duty to the source of inside informa-

\textsuperscript{55} See 15 U.S.C. § 78u-1(a)(3) (1994) ("The amount of the penalty which may be imposed on any person who, at the time of the violation, directly or indirectly controlled the person who committed such violation, shall be determined by the court. . . .").

\textsuperscript{56} See, e.g., Chestman, 947 F.2d at 566.

\textsuperscript{57} 117 S. Ct. 2199 (1997).


\textsuperscript{59} O'Hagan, 92 F.3d at 620-21.

\textsuperscript{60} 664 F.2d 12 (2d Cir. 1981) (finding Rule 10b-5 criminal misappropriation liability for a stockbroker who traded on inside information gained in breach of a third party's duty of confidentiality). See also Mylett, 97 F.3d at 667 (affirming defendant's conviction based upon the misappropriation theory); 2 Settle \textit{AT&T Insider Charges}, N.Y. TIMES, Jan. 23, 1997, at D9.

\textsuperscript{61} See Newman, 664 F.2d at 16.

\textsuperscript{62} See id. at 18.

\textsuperscript{63} See \textit{id}. See also Mylett, 97 F.3d at 667 ("[T]he only additional showing needed to establish misappropriation is that the information was acquired through a breach of a relationship of trust and confidence.").
tion may be held criminally liable if the person trades on inside information gained in the course of a fiduciary relationship.\textsuperscript{64}

\textit{Neuman}'s broad "any person in connection with" interpretation served as the basis for criticism of the misappropriation theory. \textit{United States v. Bryan}\textsuperscript{65} illustrates the rationale of the circuits rejecting the misappropriation theory, holding that one cannot be found criminally liable under the misappropriation theory where a fiduciary duty is not owed to either a purchaser or seller of securities.\textsuperscript{66} The court stated that the misappropriation theory transforms Rule 10b-5 from a rule intended to govern and protect relationships between market participants into a federal common law governing and protecting any and all trust relationships.\textsuperscript{67} Accordingly, the \textit{Bryan} court found the misappropriation theory overly broad by virtue of its creation of criminal liability for all breaches of fiduciary duty committed in the course of obtaining information upon which to trade securities.\textsuperscript{68}

In \textit{United States v. O'Hagan},\textsuperscript{69} the Eighth Circuit added to the \textit{Bryan} court's rejection of the misappropriation theory the additional criticism that the plain text of § 10(b) and Rule 10b-5 does not support the misappropriation theory insofar as the misappropriation theory fails to require criminal liability to be based upon deception, a requirement

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\item[64.] See \textit{Neuman}, 664 F.2d at 18.
\item[65.] 58 F.3d 933 (4th Cir. 1995) (declining to find criminal Rule 10b-5 misappropriation liability for head of West Virginia state lottery who traded on inside information gained in the course of employment). \textit{See generally} Jay G. Merwin, Jr., \textit{Misappropriation Theory Liability Awaits a Clear Signal}, 51 BUS. LAW. 803 (1996) (discussing the impact of the \textit{Bryan} decision on Rule 10b-5 case law).
\item[66.] See \textit{Bryan}, 58 F.3d at 952.
\item[67.] \textit{Id.} at 950. \textit{See generally id. at} 949 (citing Santa Fe Indus. v. Green, 430 U.S. 462, 473-74 (1977), to support the argument that a breach of a fiduciary duty, even in connection with a purchase or sale of securities, does not give rise to liability under 10b-5 absent deception); \textit{id.} at 953 (arguing that the misappropriation theory is redundant insofar as it criminalizes activities already covered under the mail or wire fraud statutes).
\item[68.] \textit{See generally} Timothy J. Horman, Comment, \textit{In Defense of United States v. Bryan: Why the Misappropriation Theory Is Indefensible}, 64 FORDHAM L. REV. 2455, 2493 (1996). Horman makes five arguments against the misappropriation theory: (1) the text of § 10(b) and Rule 10b-5 do not support liability based upon the misappropriation theory; (2) the legislative history do not evince a Congressional intent in favor of the theory; (3) the use of the misappropriation theory contravenes Supreme Court precedent; (4) application of the misappropriation theory has been inconsistent and unpredictable; and (5) sufficient alternatives exist to capture the illegal behavior encompassed by the misappropriation theory. \textit{Id.} \textit{But see} Marc Mellett, Comment, \textit{Is There Life After Bryan?: The Validity of Rule 10b-5's Misappropriation Theory}, 34 DUQ. L. REV. 1057, 1081 (1996) (arguing that both the language and history of § 10(b) and Rule 10b-5 support the misappropriation theory).
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that § 10(b) and Rule 10b-5 mandate. Specifically, the O'Hagan court stated that the misappropriation theory fails because it does not require a particularized showing of misrepresentation or nondisclosure. Rather, the misappropriation theory finds criminal liability for a breach of a fiduciary duty in connection with any person, regardless of whether this person is a buyer or seller of securities. Thus, in O'Hagan the Eighth Circuit added the criticism that the misappropriation theory allows for criminal liability to accrue where there has been no particularized showing of fraud or deceit.

On appeal, the Supreme Court accommodated the Eighth Circuit's criticisms in O'Hagan by moving away from emphasizing breach of fiduciary duty as a basis for Rule 10b-5 misappropriation liability and moving toward an emphasis on deceptive device as central to Rule 10b-5 misappropriation liability. Under the Supreme Court's analysis in O'Hagan, deception is seen as akin to embezzlement, and exists irrespective of whether the party is deceiving a buyer or seller of securities. In citing embezzlement as a model for the particular type of deceptive practice Rule 10b-5 seeks to sanction, the Court was able to meet the Eighth Circuit's criticisms. Accordingly, under the Supreme Court's O'Hagan analysis, one is liable via the misappropriation theory of Rule 10b-5 where one's conduct involves a willful breach of a fiduciary duty via a deceptive device or contrivance used in connection with the obtaining of nonpublic material information in the purchase or sale of a security.

In many ways, the embezzlement model outlined by the Supreme Court in O'Hagan is an extension of the theft model of the misappropriation theory of Rule 10b-5. Supporters of the misappropriation theory often cite Chief Justice Burger's dissenting opinion in Chiarella v. United States for the proposition that the misappropriation theory

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70. O'Hagan, 92 F.3d at 617.
71. Id. at 618.
72. See id. at 619 ("[T]he misappropriation theory which allows the imposition of § 10(b) liability even though no market participant was deceived or defrauded cannot be defended.").
73. See O'Hagan, 117 S. Ct. at 2209 ("§ 10(b) is not an all-purpose breach of fiduciary duty ban; rather, it trains on conduct involving manipulation or deception.").
74. See id. at 2208 (defining embezzlement as "the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another" (quoting Grin v. Shine, 187 U.S. 181, 189 (1902))).
75. Id. at 2206-07.
76. Id. at 2214.
77. Id. at 2209.
Specifically, the defendant in *Chiarella* attempted to exercise control (i.e., asportation) over another's property in violation of that person's property rights. The type of theft Chief Justice Burger referred to in *Chiarella* was larceny, since the defendant in *Chiarella* attempted to exercise control over another's property in the form of information. Theft as larceny, however, is atypical in terms of the fact patterns to which it can be applied. Most fact patterns where the misappropriation theory is applied involve deception and fraud at the front end of a relationship serving as a pretext for one to gain possession of inside information. Prior to *O'Hagan*, the debate surrounding the misappropriation theory centered on the goal of the theory in terms of what it sought to sanction. The Supreme Court's *O'Hagan* decision resolved in the negative the issue of whether theft as larceny alone could serve as the basis for criminal liability, for the Supreme Court found that the existence of deceptive practices was an integral part of Rule 10b-5 misappropriation.

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80. See generally Sanford H. Kadish & Stephen J. Schulhofer, *Criminal Law and Its Processes* 1088-1090 (6th ed. 1995). The authors cite various theft consolidation statutes, which consolidate crimes known at common law as larceny, embezzlement, and theft by deception/larceny by trick, but which today are generally known as theft.

81. See id. at 1043.

82. See *Chiarella*, 445 U.S. at 244-45 (Chiarella stated, "I looked at the these various documents and I deciphered them and I decoded them and I used that information as a basis for purchasing stock."). *See also* *O'Hagan*, 117 S. Ct. at 2208 (citing confidential information as a form of property).

83. See, e.g., United States v. Willis, 778 F. Supp. 205 (S.D.N.Y. 1991) (defendant traded on inside information gained under the pretext that he was victim's psychiatrist); United States v. Reed, 601 F. Supp. 685 (S.D.N.Y. 1985) (defendant traded on inside information gained under the pretext that he was obtaining the inside information as part of his role as the son of victim). *But see*, e.g., SEC v. Cherif, 933 F.2d 403, 408 (7th Cir. 1991) (finding civil liability under the misappropriation theory for acts that were theft-like, but not fraudulent).

84. See *O'Hagan*, 117 S. Ct. at 2208, n.6. *See generally* *Chiarella*, 445 U.S. at 239-46 (arguing that Rule 10b-5 should sanction any type of misappropriation or theft of inside information); Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 122 (1984). Aldave states: "When one simply steals information from a stranger, his trading on the information does not involve deception or fraud, and therefore should not be held to violate Rule 10b-5." Id.
liability. That decision, however, creates the potential for a new debate regarding Rule 10b-5. Namely, O’Hagan raises the issue of which model should be implemented to sanction the types of deceptive, fraudulent practices that are used as a pretext to obtain inside information.

III. THE LANGUAGE AND INTENT BEHIND THE § 10(B) REGIME

The language and intent behind § 10(b) and Rule 10b-5 can support a broad notion of criminal liability. While the Court in O’Hagan looked to an embezzlement model of criminal liability to define the scope of liability under the misappropriation theory, the language and wording of both § 10(b) and Rule 10b-5 can support a broader form of liability. This broader form of liability could be expressed as a theft by deception model of the Rule 10b-5 misappropriation theory. The present sophistication of insider trading legitimates this broader sanction regime.

Unlike the embezzlement model, the theft by deception model accurately reflects both the language and intent behind the § 10(b) regime. The intent was first expressed in Congressional statements regarding the purposes of the investigations into stock exchange practices. Specifically, one of the purposes was stated as: “To make a thorough, and complete investigation . . . [of] the desirability of limiting or prohibiting the use of the mails, the telegraph, the telephone, and any other facilities of interstate commerce or communication with respect to any such operations, and practices deemed fraudulent, or contrary to the public interest.” This passage illustrates congressional concern with fraudulent practices and practices contrary to the public interest. This concern is reflected in the language of § 10(b): “It shall be unlawful for any person . . . [t]o use or employ . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.” It is also reflected in Rule 10b-5: “It shall be unlawful for any person, directly or indirectly, . . . [t]o engage in

85. See O’Hagan, 117 S. Ct. at 2211. See also Chiarella, 445 U.S. at 245.
86. See O’Hagan, 117 S. Ct. at 2221 (Thomas, J., dissenting) (describing the majority’s embezzlement analogy).
87. See id. at 2208 (describing the targets of the misappropriation theory as those who “pretend loyalty to the principle while secretly converting the principal’s information for personal gain”).
88. 77 CONG. REC. 1101 (1933).
89. See 15 U.S.C. § 78j;
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." The broad wording of § 10(b), reflected in the equally broad wording of Rule 10b-5, points to a congressional intent for the § 10(b) regime to cover a variety of deceptive practices. Thus, it can be inferred that Congress intended criminal liability under the § 10(b) regime where one uses any type of fraud as a pretext to gain possession of inside information to be used in a securities transaction.

There are two common law models for sanctioning what could loosely be termed the fraudulent, deceptive misappropriation of property in the form of inside information. The first model is embezzlement. In O'Hagan, the Supreme Court defined embezzlement as the fraudulent appropriation to one's own use of money or goods entrusted to one's care by another. The creation of embezzlement as a common law crime can be seen as a response to the deficiencies of larceny. Larceny only sanctioned the asportation of an owner's property in violation of an owner's property rights. Where, however, one is given permission by an owner to take property and that person takes the property, but uses it for purposes other than that for which permission was granted (for example, the party converts the property for personal use, rather than use for the benefit of the owner), it cannot be said that that person committed larceny. Thus, the

90. See 17 C.F.R. § 240.10b-5.
91. See generally O'Hagan, 117 S. Ct. at 2209-10 (describing the goal of prohibiting deception as maintaining fairness and honesty in the markets). Cf. Icm Anabtawi, Note, Toward a Definition of Insider Trading, 41 STAN. L. REV. 377, 387-90 (1989). Anabtawi argues for an economic purpose to the prohibitions on deceptive practices used to obtain inside information. Insider trading has the effect of driving risk averse participants out of the market by virtue of the fact that these participants are less willing to invest where there is less certainty regarding the true price of stock. The upshot of fewer market participants is an increase in the cost of capital. Id.
92. See Nat Stern, The Constitutionalization of Rule 10b-5, 27 RUTGERS L.J. 1, 13-14 (1995). Stern argues that the use of the word "any" in § 10(b) and Rule 10b-5 supports a broad, sweeping interpretation of both § 10(b) and Rule 10b-5. Stern states: "Nothing could be plainer about § 10(b) than its breadth: it forbids the use of 'any manipulative or deceptive device or contrivance' in violation of SEC rules governing exchange of securities. This categorical prohibition, implemented by Rule 10b-5, expresses a sweeping ban on fraudulent trading activities. . . . [T]here is no reason to doubt that § 10(b) means exactly what it says." Id.
93. See O'Hagan, 117 S. Ct. at 2208 ("[M]isappropriators . . . deal in deception. A fiduciary who '[pretends] loyalty to the principle while secretly converting the principle's information for personal gain' . . . 'dupes' or defrauds the principle.").
94. See generally KADISH & SCHULHOFER, supra note 80, at 1042-43.
95. See id. at 1045-48. See generally George P. Fletcher, The Metamorphosis of Larceny, 89 HARV. L. REV. 469, 492-94 (1976). Fletcher describes the import of the lack of a trespassory taking as it pertains to larceny by citing the case of Topolewski v. State, 109 N.W. 1037 (Wis.
common law crime of embezzlement\textsuperscript{97} was created to fill the gaps in larceny by expanding liability to the fraudulent conversion of property. The second model is theft by deception. Theft by deception\textsuperscript{98} is a modern embodiment of the common law crime of false pretenses.\textsuperscript{99} False pretenses occurs where one obtains both possession of and title to another person's property through deception.\textsuperscript{100} Deception, for the purpose of false pretenses, is the misrepresentation of some existing fact.\textsuperscript{101} The definition of deception used in theft by deception is more expansive than the common law definition of deception used in false pretenses. Specifically, theft by deception covers deception involving the creation of false impressions of law, value, or intention.\textsuperscript{102} Thus, theft by deception covers almost any type of deceptive practice used to obtain possession of another person's property.

\begin{enumerate}
\item creates or reinforces a false impression, including false impression as to law, value, intention or other state of mind; but deception as to a person's intention to perform a promise shall not be inferred from the fact alone that he did not subsequently perform the promise; or
\item prevents another from acquiring information which would affect his judgment of a transaction; or
\item fails to correct a false impression which the deceiver previously created or reinforced, or which the deceiver knows to be influencing another to whom he stands in a fiduciary or confidential relationship.
\end{enumerate}

\textsuperscript{97} See generally JEROME HALL, THEFT, LAW, AND SOCIETY 37-40 (2d ed. 1952). Hall describes the first embezzlement statutes as covering servants embezzling their master's property, brokers, merchants, bankers, attorneys and other agents misappropriating property entrusted to them, parties fraudulently pledging goods entrusted to them for sale, trustees under express trusts fraudulently disposing of trust funds, and bailees stealing goods bailed to them. Id.

\textsuperscript{98} MODEL PENAL CODE § 223.3(1) (1962). The Model Penal Code defines theft by deception as occurring when a person purposefully obtains property of another by deception. A person deceives if he purposely:

\textsuperscript{99} MODEL PENAL CODE § 223.3 cmt. 1 (1962).

\textsuperscript{100} See People v. Ashley, 267 P.2d 271, 279 (Cal. 1954) ("Larceny by trick and device is the appropriation of property, the possession of which was fraudulently acquired; obtaining property by false pretenses is the fraudulent or deceitful acquisition both of title and possession."); see also Arthur R. Pearce, Theft by False Promises, 101 U. PA. L. REV. 967, 987 (1953). Pearce compares the crimes of false pretenses and larceny by trick. "False pretenses is theft by deceit. The misappropriation it punishes must be effected by communication to the owner. Larceny by trick is theft by stealth. It punishes misappropriation effected by unauthorized disposition of the owner's property. The former focuses on defendant's behavior while face to face with the owner. . . . The focus of the latter is upon defendant's behavior behind the owner's back." Id.

\textsuperscript{101} See generally United States v. Durland, 161 U.S. 306, 312-313 (1893) (arguing that federal mail and wire fraud statutes act to encompass common law false pretenses, and in fact are broader in scope).

\textsuperscript{102} See MODEL PENAL CODE § 223.3(1).
Neither the wording of, nor the congressional intent behind, the § 10(b) regime reflect the notion that criminal liability for violations of the § 10(b) regime is limited to breaches of fiduciary duty. The fiduciary duty element of the Rule 10b-5 misappropriation theory as expressed in the embezzlement model is a product not of congressional intent, but rather SEC rule-making authority under § 10(b). The roots of the fiduciary duty element can be traced to the fiduciary duty that exists between a corporate director or officer and the corporation’s beneficiaries in the form of shareholders. The problem with the fiduciary duty element is that the wording, and in particular the congressional intent, behind the § 10(b) regime reflect a broader notion of liability. Specifically, the language of § 10(b) and Rule 10b-5 reflect the creation of a broad sanctioning power to control any type of deceptive pretext used to gain property in the form of inside information. Theft by deception reflects similar breadth by virtue of its use of language seeking to sanction deception involving the creation of false impressions as to law, value, or intention. Accordingly, while the embezzlement model limits liability to breaches of fiduciary duty, the § 10(b) regime’s language and intent to proscribe any deceptive device or fraudulent practice is better reflected in the theft by deception model.

103. See 15 U.S.C. § 78j; 17 C.F.R. § 240.10b-5. Both § 10(b) and Rule 10b-5 use broad wording that seeks to proscribe any manipulative or deceptive device or contrivance used in connection with a securities transaction.


Although the primary function of Rule 10b-5 was to extend a remedy to a defrauded seller, the courts and this Commission have held that it is also applicable to a defrauded buyer. There is no valid reason why persons who purchase stock from an officer, director, or other person having the responsibilities of an ‘insider’ should not have the same protection afforded by disclosure of special information as persons who sell stock to them. Whatever distinctions may have existed at common law based on the view that an officer or director may stand in a fiduciary relationship to existing stockholders from whom he purchases but not to members of the public to whom he sells, it is clearly not appropriate to introduce these into the broader antifraud concepts embodied in the securities acts.

Id.

105. See generally id. n.23.

106. See 15 U.S.C. § 78j. Section 10(b) allows the SEC to promulgate rules as necessary or appropriate in the public interest to proscribe any manipulative device or contrivance in contravention of SEC rules and regulations.

107. See MODEL PENAL CODE § 223.3(1). It is clear that, of these three proscriptions, false impression as to intention would be the most relevant for the purposes of the § 10(b) regime.

108. See 15 U.S.C. § 78j. Section 10(b) seeks to proscribe any manipulative or deceptive device.
The fiduciary duty element of the Rule 10b-5 misappropriation theory fails to address both of the ways that a deceptive pretext can be used to obtain inside information in a nonfiduciary context and the pervasive nature of insider trading.\textsuperscript{109} Today, fact patterns exist involving the use of deception as a pretext for transfers of inside information that do not involve a fiduciary relationship. For example, in United States v. Cherif,\textsuperscript{110} the defendant, a former bank employee, convinced his girlfriend, a current employee at the bank, to create a fictitious memo allowing the defendant access to the bank’s specialized finance department. Through his ability to access the specialized finance department, the defendant was able to gain confidential information regarding client companies’ future business strategy, management structure, and financial performance.\textsuperscript{111} The deceptive pretext used in this case arose not from the breach of a fiduciary duty, but rather from the perpetration of an outright fraud on the possessor of the information (i.e., the bank). Thus, there are instances in which the fiduciary duty element is outstripped as a sanctional tool by the sophistication of those employing deceptive pretexts.

Insider trading becomes pervasive by virtue of the “word of mouth” dissemination of inside information. In Cherif, the Court noted the word of mouth phenomenon when it observed that “Cherif was not the only person to profit from trading on the information he obtained from the bank. Cherif shared the information with (possibly among others) William Bronc, Jr. Bronc had been a fellow employee of Cherif’s . . . and was one of Cherif’s best friends.”\textsuperscript{112} The phenomenon of sharing fraudulently obtained inside information with others through word of mouth is nothing new,\textsuperscript{113} and has been heavily documented in the media.\textsuperscript{114}

One example of the word of mouth phenomenon is the case of Susan Keary, Graeme Davies, Jeffrey Morris, and Gerard Murphy. Keary was an administrative assistant to Benjamin Lambert, a member of the board of directors of Hilton Hotels.\textsuperscript{115} While at a New York City bar, Keary met Davies, a businessman from Liverpool, England. Keary traveled to Liverpool to visit Davies and was introduced to a

\textsuperscript{109} See supra note 2.
\textsuperscript{110} 943 F.2d 692 (7th Cir. 1991).
\textsuperscript{111} Id. at 694.
\textsuperscript{112} Id. at 695.
\textsuperscript{113} See supra note 23.
\textsuperscript{114} Nick Gilbert, Word of Mouth: Apparent Insider Trading in Hilton Hotels Leads Back to a Director’s Secretary, FIN. WORLD, May 9, 1995, at 38.
\textsuperscript{115} Id. at 39.
man named Gerard, later discovered to be Gerard Murphy. One of Murphy’s business associates was Morris, a Leeds, England, businessman. Keary left Liverpool on November 14, 1994, telling Davies that she had to return to New York to make arrangements for her boss, Lambert, to attend a Hilton board meeting. During this same period, Hilton was contemplating “ways to enhance shareholder value,” meaning that Hilton Hotels was potentially looking to sell. This information was not public; it was only known to a select group of insiders such as Lambert. On November 15th, Keary spoke to Davies. On that same day, Morris began to buy Hilton call options and common stock. Morris gorged himself on Hilton options, buying 595 out of 597 options traded on November 15th. Keary again spoke to Davis on November 17th, and on that same day Murphy and Morris executed their options and sold their stock. During the period between November 15th and 17th, the day Hilton announced they were looking for ways to enhance shareholder value, Hilton stock shot up $10, netting Murphy and Morris a combined profit of $425,000. Murphy and Morris were not the only ones who benefited from the inside information they obtained; Murphy’s mother, wife, two sisters, and brother-in-law also profited. The SEC brought a civil action against Murphy, who failed to respond to service of process. A default judgment was entered against him, resulting in the seizure of $301,000 in profits and a $157,000 fine. Morris has eluded SEC prosecution.

While this may be an extreme example, it reflects the way that word of mouth is used as a vehicle to disseminate inside information obtained through a deceptive pretext. Word of mouth dissemination of inside information is largely unseen and is hard to sanction. Typically, inside information disseminated through word of mouth is exchanged via a “friend of a friend,” and only a small portion of

116. Id.
117. Id. at 38.
118. Id. at 39.
119. Id. at 40.
120. Gilbert, supra note 114, at 38.
121. Id.
122. Id.
123. Id. Neither Keary, Davies, nor Lambert faced SEC prosecution since they did not trade on the inside information obtained.
125. Id. at 35.
parties exchanging information in this manner are caught.\textsuperscript{126} Moreover, the civil penalties are small, normally constituting a disgorgement of illicit profits and a fine.\textsuperscript{127} Accordingly, a strong sanction regime is needed to deter parties from engaging in deceptive pretexts to obtain inside information.

While the pervasive nature of insider trading can possibly be addressed through more vigilant prosecution and stiffer fines and penalties,\textsuperscript{128} such a remedy fails to address the increasing sophistication of insider trading.\textsuperscript{129} Cherif illustrates the deficiencies of the embezzlement model, reflecting as it does the increasing sophistication of the deceptive practices presently being employed, practices that go beyond the use of a fiduciary duty as a pretext to obtain inside information. Although the defendant in Cherif was eventually convicted of violating the mail and wire fraud statutes,\textsuperscript{130} it seems that one who uses deception as a pretext to gain inside information upon which to trade securities should be liable under the securities laws and not solely on the basis of fraudulent use of the mails. Moreover, the incentives\textsuperscript{131} to obtain inside information make it clear that in the future ever more sophisticated forms of deception will be employed to gain such information. Therefore, given the sophistication of insider trading and the incentives to engage in it, a broader type of criminal liability is needed to cover any type of willful, deceptive pretext used to obtain inside information upon which to trade securities. The theft by deception model reflects such a broader type of criminal liability.

IV. MEETING THE CRITICISM OF THE MISAPPROPRIATION THEORY

The dissenting opinions of Justices Scalia and Thomas center on their concerns for preserving federalism and substantive due process.

\textsuperscript{126} Id. at 34.
\textsuperscript{127} Id. at 35.
\textsuperscript{128} See generally id. Schroeder cites the relatively minor civil penalties as a reason for bringing more Rule 10b-5 criminal actions.
\textsuperscript{130} See Cherif, 943 F.3d at 695. See generally United States v. Willis, 737 F. Supp. 205, 275 (S.D.N.Y. 1991) (describing mail and wire fraud liability as accruing where one receives confirmation of the fraudulently traded stock through the mails).
\textsuperscript{131} See, e.g., O'Hagan, 92 F.3d at 614 (defendant made $4 million through the use of inside information); Ruggiero, 56 F.3d at 650 (defendant made $665,000 through the use of inside information); United States v. Reed, 601 F. Supp. 685, 691 (S.D.N.Y. 1985) (defendant made $431,000 through the use of inside information).
Justice Scalia expresses his concern for the impact of the embezzlement model of the Rule 10b-5 misappropriation theory on federalism by citing how this model fails to comply with the "principle of leniency." Justice Thomas expresses his concern for the issue of substantive due process by arguing that the majority in O'Hagan has promulgated "a new rule," thereby failing to give adequate notice for the purposes of substantive due process. While both of these criticisms have merit, the language and congressional intent behind the § 10(b) regime, along with the practical realities of prosecuting securities fraud cases, tend to diminish the import of these criticisms.

Contrary to the view expressed by Justice Scalia, both the embezzlement model and the theft by deception model of the misappropriation theory of Rule 10b-5 comport with the principle of leniency and its underlying policy considerations. The principle of leniency states that where a statute is ambiguous, the ambiguities are to be resolved in favor of a criminal defendant. Reno v. Koray outlines the test for determining the applicability of the principle of leniency. In Koray, the Court found the principle of leniency to apply where, "if after seizing everything from which aid can be derived, . . . we can make no more than a guess as to what Congress intended." The notion of "aid" for the purpose of leniency can be derived from the language of a statute, other similarly worded provisions, or the

132. See O'Hagan, 117 S. Ct. at 2220.
133. See id. at 2220-30.
134. See generally Carol B. Swanson, Reinventing Insider Trading: The Supreme Court Misappropriates the Misappropriation Theory, 32 WAKE FOREST L. REV. 1157, 1212 (1997) (arguing that the ill-defined scope of the Rule 10b-5 misappropriation theory detracts from its sanctional value); Michael D. Monico and Jacqueline S. Jacobson, Supreme Court Turns Insider Trading Inside Out, 21 CHAMPION 12, 15 (Dec. 1997) (arguing that a broad application of the misappropriation theory could lead to inconsistent sanctional goals).
135. See generally O'Hagan, 117 S. Ct. at 2220. Justice Scalia asserts § 10(b) must be construed to require the manipulation or deception of a party to a securities transaction. The language of § 10(b) and Rule 10b-5 refutes Scalia's assertion by referring to deception involving purchases and sales of securities, rather than purchasers or sellers of securities. This, however, is a minor critique of Scalia's dissent, the thrust of which is the issue of whether the embezzlement model of the Rule 10b-5 misappropriation theory comports with the rule of leniency.
136. See id. at 2206-07. See generally 15 U.S.C. § 78j ("operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security"). The "person" for the purposes of the misappropriation theory of Rule 10b-5 is the party with whom a fiduciary duty is broken.
140. Id. at 65.
legislative history of a statute. The language of § 10(b), and in particular Rule 10b-5, speaks to the use of "any act, practice, or course of business which . . . would operate as a fraud upon any person, in connection with the purchase or sale of any security." The first part of this passage addresses the scope of the acts covered, specifically the proscription of any act which would operate as a fraud used to purchase or sell securities. The second part of this passage addresses the parties covered by the act, in particular those engaged in the purchase or sale of securities through deceptive means. Both § 10(b) and Rule 10b-5 use extremely broad language covering a variety of acts that could be considered fraudulent. Embezzlement is a subclass of the more general class of fraud; embezzlement only proscribes fraud arising from breach of a fiduciary duty. Theft by deception, when compared to embezzlement, is more akin to the general class of fraud cited in the language of § 10(b) and Rule 10b-5. Specifically, theft by deception proscribes the creation of false impressions as to intentions, rather than the mere use of a fiduciary relationship as a fraudulent pretext. Accordingly, the embezzlement model is a narrow reading of statutory language that can support a broader sanctional model in the form of theft by deception.

The Court's decision in O'Hagan comports both with similarly worded provisions of the 1934 Act and the history of the 1934 Act when one looks to an aggregate of other policy considerations. The 1934 Act was created as a response to the variety of fraudulent, deceptive schemes perpetrated by market insiders against market outsiders. These schemes sought to exploit informational disparities between parties trading securities. Similarly, trading on inside information obtained through a deceptive pretext has the effect of creating an informational disparity between those who have inside information and those who do not. In Chiarella v. United States,

141. See generally id. at 52-61.
142. See 17 C.F.R. § 240.10b-5.
143. See O'Hagan, 117 S. Ct. at 2208.
144. See MODEL PENAL CODE § 223.3(1).
145. See 77 CONG. REC. 3324-25 (1933).
146. See supra notes 15, 16. See also 78 CONG. REC. 8173 (1934), which states:
   Summing up this statement to get a general conclusion on just one stock, we find a stock very inactive, because closely held, raised from $6 plus in February 1932 to $89 7/8 on July 18, 1933, then dropping to around $30, and at the time of the hearing selling at about $40. My comments on it do not touch on whether it is valuable and with ample background of business activity, but that various dummy processes and the work of options, syndicates, pools, and so forth, created a false sense of activity that led the public to invest.
the Supreme Court defined the type of disparities covered by the § 10(b) regime by rejecting the fraud on the market theory.\textsuperscript{148} Namely, under the Court’s analysis in Chiarella, informational disparities in the market were not, by themselves, seen as a reason to preserve fairness, honesty, and integrity in the markets.\textsuperscript{149} Rather, the values of fairness, honesty, and integrity were seen to proscribe a market participant from engaging in deceptive and fraudulent practices which create informational disparities.\textsuperscript{150} While O’Hagan is consistent with the Chiarella court’s emphasis on proscribing the fraudulent acts of individuals, it is unclear whether the victim in O’Hagan is the type of individual that Congress envisioned protecting via the § 10(b) regime. In particular, much of the 1934 Act is devoted to protecting those involved in a securities transaction and not those outside such a transaction. Despite this inconsistency, it is clear that Congress was attempting to proscribe a variety of deceptive practices via the § 10(b) regime, and the breach of a fiduciary duty in the course of obtaining inside information could be one such deceptive practice that Congress envisioned. Moreover, the ever increasing sophistication of insider trading\textsuperscript{151} and congressional reluctance to define insider trading\textsuperscript{152} necessitate such a broad sanction regime. Accordingly, the congressional intent behind the § 10(b) regime, the increasing sophistication of insider trading, and congressional reluctance to define insider trading support the broad language of both the embezzlement model and a theft by deception model of the Rule 10b-5 misappropriation theory.

The Court’s decision in O’Hagan comports with the policy considerations underlying the principle of lenity. Of the three policies underlying the rule of lenity,\textsuperscript{153} that relating to the Supreme Court’s reluctance to define as a federal crime conduct traditionally denounced by states as criminal is most at risk of being violated by a broad reading of the Rule 10b-5 misappropriation theory. At its root, this

\begin{itemize}
  \item \textsuperscript{148} See id. at 232-34.
  \item \textsuperscript{149} See id. See generally supra note 4 (I.T.S.F.E.A. and I.T.S.A. citing values of fairness, honesty, and integrity in the markets as central value concerns).
  \item \textsuperscript{150} See generally Chiarella, 445 U.S. at 228-29. ("This relationship gives rise to a duty to disclose because of the 'necessity of preventing a corporate insider from . . . taking unfair advantage of the uninformed minority stockholders.").
  \item \textsuperscript{151} See, e.g., Cherif, 943 F.3d 692.
  \item \textsuperscript{152} See supra note 50. The I.T.S.F.E.A. drafting committee did not believe that a failure to define insider trading impedes the progress of needed enforcement reforms.
  \item \textsuperscript{153} See generally Bass, 404 U.S. at 348 (the three policy considerations behind the principle of lenity can be generally described as concerning substantive due process, separation of powers, and federalism).
\end{itemize}
is a problem of federalism, a problem the court in Bryan recognized when it observed:

Moreover, while the courts adopting the misappropriation theory incant that the breach of a fiduciary relationship is a necessary element of the offense, in principle, if not in reality, these courts would be obliged to find liability in the case of simple theft by an employee, even where no fiduciary duty has been breached, for the raison d'etre of the misappropriation theory in fact is concern over, "the unfairness inherent in trading on [stolen] information." And as that court further noted: "The only alternative to the inevitable patchwork of criminal standards that will develop under the theory would be the effective federalization of relationships historically regulated by the states." The above passages reflect the Supreme Court's concern that a regime of federal common law crimes could be created under § 10(b). Such a common law scheme, while not only problematic in itself, would also be problematic because it would allow the SEC and federal courts to define what acts constitute a deceptive pretext under the broad wording of § 10(b) and Rule 10b-5. This is problematic because, based on the language of § 10(b) and Rule 10b-5, the SEC could theoretically seek to criminally sanction individuals who use deceptive practices to obtain money and then use this money to trade securities. Such a sanction power would intrude upon the various existing state sanctional regimes which proscribe criminal theft and fraud. The result of such an intrusion would be a unilateral shifting of power from the states to the federal government, and in particular the SEC.

154. See generally Younger v. Harris, 401 U.S. 37, 44 (1971) ("What the concept does represent is a system in which there is sensitivity to the legitimate interests of both State and National governments, and in which the National Government, anxious though it may be to vindicate and protect federal rights and federal interests, always endeavors to do so in ways that will not unduly interfere with the legitimate activities of the States."); Tarble's Case, 13 Wall. 397, 406, 20 L. Ed. 597 (U.S. 1872) ("There are within the territorial limits of each state two governments, restricted in their spheres of action, but independent of each other, and supreme within their respective spheres.").

155. See Bryan, 58 F.3d at 951 (quoting Chiarella, 445 U.S. at 241).

156. Id.

157. See generally KADISH & SCHULHOFER, supra note 80, at 297-98. The authors discuss the demise of common law crimes on the basis that they violate due process by not providing notice to would be violators. Id.

Overlapping jurisdiction is not a problem for federalism. Double jeopardy statutes not only work to preserve individual rights, but federalism as well. Specifically, if a state prosecutes an individual the federal government will not, and vice-versa.\textsuperscript{159} Furthermore, most states do not have the resources, logistical support, or desire to enforce laws against securities fraud.\textsuperscript{160} As the Hilton stock example illustrates, securities fraud can involve multiple parties in multiple jurisdictions.\textsuperscript{161} Tracking parties who commit securities fraud is time consuming and costly. Even if the definition of fraud in Rule 10b-5 was expanded to cover fraudulent acts proscribed by state regimes, most states would defer prosecution of these individuals to the federal government. Thus, a unilateral shift in power to the federal government would have little effect.

Contrary to the dissent of Justice Thomas, an individual’s right to substantive due process is not violated by the failure to codify the misappropriation theory of Rule 10b-5. According to Justice Thomas:

\begin{quote}
I need not address the coherence, or lack thereof, of the majority’s new theory, for it suffers from a far greater, and dispositive, flaw: It is not the theory offered by the Commission. Indeed, as far as we know from the majority’s opinion, this new theory has never been proposed by the Commission, much less adopted by rule or otherwise.\textsuperscript{162}
\end{quote}

As Justice Thomas continued: “Putting aside the dubious validity of an open ended delegation to an independent agency to go forth and create regulations criminalizing ‘fraud,’ in this case we do not even have a formal regulation embodying the agency’s misappropriation theory.”\textsuperscript{163} Justice Thomas’s dissent points to the fact that the SEC has failed to codify the misappropriation theory via its enforcement power under § 10(b).\textsuperscript{164} The result of such a failure to codify the misappropriation theory is a lack of adequate notice for due process purposes.

\textsuperscript{159} See, e.g., COLO. REV. STAT. § 18-1-303 (second trial barred by prosecution in another jurisdiction); WASH. REV. CODE § 10.43.030 (1996) (foreign conviction or acquittal); N.J. STAT. ANN. § 2C:1-11 (West 1995) (former prosecution in another jurisdiction: when a bar); ILL. COMP. STAT. ANN. ch. 720 para. 5/3-4 (effect of former prosecution) (West 1993); 1996 CAL. STAT. ANN. § 656 (offenses also punishable by foreign law; double jeopardy).
\textsuperscript{160} See supra note 114.
\textsuperscript{161} See supra note 115.
\textsuperscript{162} O’Hagan, 117 S. Ct. at 2224 (Thomas, J., dissenting).
\textsuperscript{163} Id. at 2226.
The "willfulness" requirement of Rule 10b-5 solves the substantive due process concerns put forth by Justice Thomas. Substantive due process requires that a defendant be given fair warning of the law in a language the common person understands and, more importantly, what the law intends to do if it is violated.\textsuperscript{165} One only incurs Rule 10b-5 liability where one willfully\textsuperscript{166} violates Rule 10b-5; that is, one knows of the rule and violates the rule anyway.\textsuperscript{167} The willfulness element tends to alleviate any of the substantive due process concerns put forth by Justice Thomas. Accordingly, the language of Rule 10b-5 meets the notice requirement for substantive due process purposes.

V. CONCLUSION

Utility dictates that insider trading be proscribed through a broadly worded sanction regime. Historically, inside information has been the vehicle by which fraudulent practices were perpetrated in the stock market.\textsuperscript{168} These fraudulent practices have grown in recent years from groups of individuals trading via stock pools,\textsuperscript{169} to the present day sophistication of individuals such as Boesky\textsuperscript{170} and Cherif.\textsuperscript{171} If one adds in both the "word of mouth"\textsuperscript{172} phenomenon and incentives to engage in insider trading,\textsuperscript{173} it is clear that only a broad sanction regime will be able to address the breadth of the problem as it presently exists.\textsuperscript{174} This broader sanction regime could be modeled on theft by deception sanctioning: the willful creation of false impression of intent in another as a deceptive pretext to gain inside information used in the buying or selling of securities. While

\textsuperscript{165} See Grandon v. United States, 494 U.S. 152, 160 (1989); Bass, 404 U.S. at 348. Cf. Papachristou v. City of Jacksonville, 405 U.S. 156 (1972) (striking down as void for vagueness a city ordinance forbidding loitering and a variety of other offenses on the basis that the ordinance failed to give a person of ordinary intelligence fair notice that a particular act is forbidden by statute); Lonzetta v. New Jersey, 306 U.S. 451, 453 (1939) ("No one may be required at peril of life, liberty, or property to speculate as to the meaning of penal statutes. All are entitled to be informed as to what the State commands or forbids.").

\textsuperscript{166} See O'Hagan, 117 S. Ct. 2214 (1997).

\textsuperscript{167} Id.

\textsuperscript{168} See Helmoop Noyes, supra note 23 (describing the use of inside information in securities trading during the 1930s).

\textsuperscript{169} See supra note 15.


\textsuperscript{171} See Cherif, 943 F.3d 692.

\textsuperscript{172} See Gilbert, supra note 114 (describing the word of mouth exchange of inside information as a vehicle for insider trading).

\textsuperscript{173} See supra note 131.

\textsuperscript{174} See generally supra note 2 (documenting various examples of insider trading cited by the media).
concerns of federalism and substantive due process act to limit such a broad reading of § 10(b) and Rule 10b-5, such concerns must be weighed against the practical realities of insider trading.