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Insider Trading, Congressional Officials, and Duties of Entrustment

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INSIDER TRADING, CONGRESSIONAL OFFICIALS, AND DUTIES OF ENTRUSTMENT

DONNA M. NAGY*

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* C. Ben Dutton Professor of Law, Indiana University Maurer School of Law – Bloomington. I presented this Article at The Role of Fiduciary Law and Trust in the Twenty-First Century: A Conference Inspired by the Work of Tamar Frankel held at Boston University School of Law on October 29, 2010. I am grateful to Professors Frankel and Kenneth Simons, the student editors, and my fellow symposium participants. The Article also has benefited from helpful insights and comments by Professors Hannah Buxbaum, Charles Geyh, Donald Langevoort, Richard Painter, Margaret Sachs, and William Wang, and from excellent research assistance by Courtney Segota.

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INTRODUCTION

A few weeks prior to this Conference on Trust and Fiduciary Law in the Twenty-First Century, the *Wall Street Journal* published a front page news article with the headline *Congress Staffers Gain from Trading in Stocks*.¹ The article reported that during the last two years, “[a]t least 72 aides on both sides of the aisle traded shares of companies that their bosses help oversee.”² One congressional spokesman told the *Journal* that “[c]ongressional staff are often privy to inside information, and an unscrupulous person could profit off that knowledge.”³

The article was, in many respects, a sequel to a *Journal* article published six years earlier with the headline *U.S. Senators’ Stock Picks Outperform the Pros*.⁴ That article reported on an academic study finding that, during the 1990s, the stock portfolios of U.S. Senators beat the market by an average of twelve percentage points.⁵ The study’s authors concluded that the “senators’ uncanny ability to know when to buy or sell their shares seems to stem from having access to information that other investors wouldn’t have.”⁶

The *Journal*’s more recent article on congressional staffers, however, interspersed legal analysis with its factual reporting. That is, the article acknowledged that “[t]he aides identified . . . say they didn’t profit by making trades based on any information gathered in the halls of Congress.”⁷ But the

¹ Brody Mullins et al., *Congress Staffers Gain from Trading in Stocks*, WALL ST. J., Oct. 11, 2010, at A1.

² *Id.* (highlighting the *Journal*’s “analysis of more than 3,000 disclosure forms covering trading activity by Capitol Hill staffers for 2008 and 2009”).

³ *Id.* (quoting Vincent Morris, spokesman for Rep. Louise Slaughter (D-N.Y.)) (internal quotation marks omitted).

⁴ Jane J. Kim, *U.S. Senators’ Stock Picks Outperform the Pros*, WALL ST. J., Oct. 26, 2004, at D2.

⁵ *Id.* (“The study’s authors, relying on financial-disclosure forms from 1993 to 1998, looked at about 6,000 common-stock transactions of about a third of the senators each year.”). The cited study is Alan J. Ziobrowski et al., *Abnormal Returns from the Common Stock Investments of the U.S. Senate*, 39 J. FIN. & QUANTITATIVE ANALYSIS 661 (2004).

⁶ Kim, *supra* note 4 (“I don’t think you need much of an imagination to realize that they’re in the know.” (quoting Professor Ziobrowski, one of the study’s co-authors) (internal quotation marks omitted)).

⁷ Mullins et al., *supra* note 1.

Journal then advanced the claim that “[e]ven if they had done so, it would be legal, because insider-trading laws don’t apply to Congress.”⁸ The *Journal* published a follow-up article the next day highlighting the proposed STOCK Act, an acronym for the Stop Trading on Congressional Knowledge Act.⁹ That article noted that the proposed legislation, which had been pending in the U.S. House of Representatives for more than four years, sought to “outlaw insider trading by Capitol Hill members and their staffs.”¹⁰ Again, though, the *Journal* followed this fact with the legal conclusion that, in the absence of new legislation, “Congress is immune from insider-trading laws.”¹¹

The *Journal*’s conclusion about the legality of insider trading by members of Congress and legislative staffers set the blogosphere and mainstream media on fire. Several securities law scholars agreed with the *Journal*’s analysis as it pertained to members of Congress, but disagreed that the conclusion also held true for legislative staffers.¹² Then-Representative Brian Baird, the

⁸ *Id.*

⁹ Tom McGinty & Brody Mullins, *Lawmaker Aims to Outlaw Insider Trading on the Hill*, WALL ST. J., Oct. 12, 2010, at A9.

¹⁰ *Id.*

¹¹ *Id.*

¹² See, e.g., Stephen M. Bainbridge, *More Evidence of Insider Trading Inside the Beltway*, PROFESSORBAINBRIDGE.COM (Oct. 11, 2010, 7:32 AM), <http://www.professorbainbridge.com/professorbainbridgecom/2010/10/more-evidence-of-insider-trading-inside-the-beltway.html> (“The key point is that the staffers have no blanket immunity . . . in the way that members of Congress do.”); Thom Lambert, *Does the Insider Trading Ban Apply to Congressional Staffers?*, TRUTH ON THE MARKET (Oct. 11, 2010, 6:22 PM), <http://truthonthemarket.com/2010/10/11/does-the-insider-trading-ban-apply-to-congressional-staffers/> (“I think [the *Journal* article is] assuming that because members of Congress may trade on material, non-public information they learn in the course of their jobs, their aides may do so as well. I don’t think that’s right.”). Professor Bainbridge has analyzed the topic of congressional insider trading in an extensive article. Stephen M. Bainbridge, *Insider Trading Inside the Beltway*, 36 J. CORP. L. 281, 285 (2011) [hereinafter Bainbridge, *Beltway I*] (“Congressional staffers and other government officials and employees could be prosecuted successfully for insider trading under the federal securities laws, but the quirks of the relevant laws almost certainly would prevent Members of Congress from being successfully prosecuted.”); see *infra* notes 171, 180, 186, 312.

Other securities and business law scholars have weighed in on these issues in the past. E.g., RICHARD W. PAINTER, GETTING THE GOVERNMENT AMERICA DESERVES: HOW ETHICS REFORM CAN MAKE A DIFFERENCE 163 (2009) (contending that the current law governing insider trading “may not be sufficiently rigorous to prevent abuses by government officials”); Jonathan R. Macey & Maureen O’Hara, *Regulation and Scholarship: Constant Companions or Occasional Bedfellows?*, 26 YALE J. ON REG. 89, 107 (2009) (maintaining that while there is a plausible theory that would render insider trading by members of Congress illegal, a narrower view of the current law might be more likely to prevail); Ziobrowski et al., *supra* note 5, at 676 (“Current law does not prohibit Senators from trading stock on the basis of information acquired in the course of performing their normal Senatorial functions.”); see also sources cited *infra* note 237. For student-written pieces, see

congressional co-author of the STOCK Act, drew no such distinction between members and staff, and opined that “[t]he public expects us to adhere to at least as high a standard as we impose on other people, and we don’t in this case.”¹³ Former Securities and Exchange Commission (SEC) Chairman Arthur Levitt then entered the fray, lamenting in a broadcast that “members of Congress and their staffs . . . benefit from an exemption that the average investor doesn’t benefit from. They’re immune from insider trading laws.”¹⁴ Media outlets were soon reporting as conventional wisdom that “while insider trading is illegal in the private sector, it is totally legal for government employees to do it” because “[b]asically, Congress passed a law making insider trading illegal for the private sector and exempted itself.”¹⁵

Matthew Barbabella et al., *Insider Trading in Congress: The Need for Regulation*, 9 J. BUS. & SEC. L. 199, 215-17 (2009) (arguing that current law reaches neither members of Congress nor legislative staffers); Andrew George, Short Essay, *Public (Self)-Service: Illegal Trading on Confidential Congressional Information*, 2 HARV. L. & POL’Y REV. 161, 163 (2008) (arguing that insider trading by members of Congress and legislative staffers is already illegal under the misappropriation theory); Bud W. Jerke, Comment, *Cashing In on Capitol Hill: Insider Trading and the Use of Political Intelligence for Profit*, 158 U. PA. L. REV. 1451, 1458-59 (2010) (arguing that insider trading by congressional officials is most likely not illegal under existing law, but advocating proposals for a change in the law governing congressional ethics rather than an amendment to the federal securities laws); Herbert T. Krimmel, Note, *The Government Insider and Rule 10b-5: A New Application for an Expanding Doctrine*, 47 S. CAL. L. REV. 1491, 1492 (1974) (arguing for a broad prohibition under the then-current law).

¹³ McGinty & Mullins, *supra* note 9 (quoting Rep. Brian Baird (D-Wash.)).

¹⁴ Arthur Levitt, *Board Member at Bloomberg LP, Talks About the U.S. Financial Services System on Bloomberg Surveillance* (Bloomberg radio broadcast Oct. 13, 2010) (transcript available through Analyst Wire, available at 2010 WLNR 20471195). Former SEC Chairman Arthur Levitt considered it “a public outrage” that Congress has yet to adopt proposed legislation that would change the law. *Id.* In his view, the failure to adopt such legislation “condones insider trading” and is “a disgrace for Congress” that “looks terrible for them” because “working on serious legislation dealing with publicly owned companies” and then trading in the shares of those companies is “just a horrible, horrible practice.” *Id.* Other former SEC officials have likewise expressed the view that current law does not prohibit insider trading by members of Congress. *See, e.g.*, Brody Mullins, *Bill Seeks to Ban Insider Trading by Lawmakers and Their Aides*, WALL. ST. J., Mar. 28, 2006, at A1 (“If a congressman learns that his committee is about to do something that would affect a company, he can go trade on that because he is not obligated to keep that information confidential He is not breaching a duty of confidentiality to anybody and therefore he would not be liable for insider trading.” (quoting former Associate Director of the SEC Enforcement Division Thomas Newkirk)).

¹⁵ Veronique de Rugy, *If This Were the Private Sector, Those Congressional Staffers Would End Up in Jail*, NAT. REV. ONLINE (Oct. 12, 2010, 5:16 PM), <http://www.nationalreview.com/corner/249553/if-were-private-sector-those-congressional-staffers-would-end-jail-veronique-de-rugy>. For additional outrage, see, for example, *Insider Trading on Capitol Hill?*, THE WEEK (Oct. 13, 2010, 6:00 AM), <http://theweek.com/article/index/208085/insider-trading-on-capitol-hill> (“[T]he truly disgusting thing is that it is perfectly legal, since

Overlooked in all of the media hullabaloo about so-called “congressional immunity” from the insider trading laws were several critical facts. First and foremost, Congress could not have “exempted itself” from its own insider trading laws because Congress has *never* enacted a federal securities law that explicitly prohibits *anyone* from insider trading. In this respect, the United States stands in contrast with a host of other countries that explicitly prohibit certain persons from trading securities on the basis of material nonpublic information.¹⁶ The law in the United States is far more nuanced because, despite persistent calls for legislation and several abandoned attempts in the late 1980s,¹⁷ Congress has never statutorily defined the offense of insider trading in securities.¹⁸ Rather, Congress has been content to allow insider trading to be prosecuted as a violation of Rule 10b-5, a general antifraud rule which the SEC promulgated pursuant to its authority under section 10(b) of the Securities Exchange Act of 1934 (Exchange Act).¹⁹ Rule 10b-5 broadly prohibits fraud and deception “in connection with the purchase or sale of any security,”²⁰ and violations of the rule may be prosecuted by the SEC as a civil offense or prosecuted by the Department of Justice (DOJ) as a crime.²¹ Thus,

insider-trading laws apply to business executives but not to members of Congress or their staffs.”); Ann Woolner, *It Isn't Insider Trading When Your Senator Does It*, BLOOMBERG BUSINESSWEEK (Oct. 13, 2010, 9:15 PM), <http://www.businessweek.com/news/2010-10-13/it-isn-t-insider-trading-when-your-senator-does-it-ann-woolner.html> (“Congress should be ashamed of itself for not passing a law forbidding conduct that is criminal if anyone else does it.”).

¹⁶ See Marc I. Steinberg, *Insider Trading Regulation – A Comparative Analysis*, 37 INT’L LAW. 153, 162 (2003).

¹⁷ See *infra* notes 34, 36-38, and accompanying text.

¹⁸ Although the federal securities laws do not explicitly prohibit insider trading, Congress has authorized the SEC to pursue stiff civil penalties against those who commit the offense. See Securities Exchange Act of 1934 § 21A, 15 U.S.C. § 78u-1 (2006) (authorizing the SEC to seek a monetary penalty of up to three times the profit gained or loss avoided for violating the federal securities laws by trading securities while in possession of material nonpublic information). Congress also addressed the topic of insider trading in section 16(b) of the Exchange Act which requires certain corporate insiders to disgorge to the issuer so-called “short-swing” profits made from purchasing and selling an issuer’s equity securities within a six-month time frame. 15 U.S.C. § 78p(b). Although one of the purposes of this provision was to prevent the unfair use of confidential corporate information, the provision applies regardless of whether the corporate insider was aware of material nonpublic information at the time of the short-swing trade. See *id.*

¹⁹ 15 U.S.C. § 78j(b).

²⁰ SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2010).

²¹ Section 32(a) of the Exchange Act authorizes fines of not more than \$5 million and/or imprisonment for not more than twenty years for willful violations of Exchange Act provisions and rules. 15 U.S.C. § 78ff(a). The DOJ may also pursue criminal prosecutions for insider trading under federal statutes prohibiting mail fraud or wire fraud, 18 U.S.C. §§ 1341, 1343 (2006), or under a relatively new federal statute prohibiting fraud in connection with the purchase or sale of securities of public companies, 18 U.S.C. § 1348 (2006)

with a single exception,²² insider trading is illegal under the federal securities laws only insofar as it can be deemed a fraudulent practice in violation of Rule 10b-5. The result is that U.S. insider trading law has been almost entirely judge-made, although much of that law has been subsequently codified in additional rules promulgated by the SEC.²³

The recent outcry over “congressional immunity” from insider trading law likewise ignores the essential body of judicial precedent that has developed over the decades. Since 1980, when the Supreme Court decided *Chiarella v. United States*,²⁴ insider trading has been viewed as a fraud on the parties to a securities transaction when those parties trade with a person who remains silent about material nonpublic information in breach of a fiduciary-like duty to disclose. Pursuant to this “classical theory,” persons who owe duties of trust and confidence to an issuer’s shareholders must either disclose all material nonpublic information in their possession or abstain from trading in the issuer’s shares.²⁵ The failure to “disclose or abstain”²⁶ in such transactions constitutes a violation of Rule 10b-5.²⁷

Moreover, since 1997, when it decided *United States v. O’Hagan*,²⁸ the Court has recognized a second theory under which insider trading can be deemed a violation of Rule 10b-5. Under the “misappropriation theory,” fraud occurs when a person owing a fiduciary-like duty to the source of material nonpublic information misappropriates that information by secretly using it to reap personal profits.²⁹ The misappropriation theory of insider trading liability thus focuses on the relationship of trust and confidence that exists between the securities trader and the source of the material nonpublic information, and regards the source as the person who is defrauded in connection with the securities transaction.³⁰

(enacted as part of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 807, 116 Stat. 745, 804).

²² When insider trading involves material nonpublic information pertaining to a tender offer, a special insider trading rule applies. Once “a substantial step” toward a tender offer has been taken, Rule 14e-3 prohibits trading or tipping by any person in possession of material nonpublic information relating to that tender offer when that person knows or has reason to know that the information is nonpublic and was received from the offeror, the target, or any person acting on behalf of either the offeror or the target. SEC Rule 14e-3, 17 C.F.R. § 240.14e-3 (2010).

²³ See *infra* note 139 and Part I.B (discussing Rule 10b5-1 and -2).

²⁴ 445 U.S. 222 (1980).

²⁵ *Id.* at 227.

²⁶ *Id.*

²⁷ See *infra* Part I.A.1.

²⁸ 521 U.S. 642 (1997).

²⁹ *Id.* at 652.

³⁰ See *infra* Part I.A.2.

Professor Tamar Frankel's recent book³¹ and earlier writings on fiduciary law and duties of entrustment³² can help us to see precisely why insider trading by members of Congress and legislative staffers is already illegal under present law and why enactment of the proposed STOCK Act is not only unnecessary, but would also narrow considerably the present law that would apply to their securities transactions in the absence of an explicit statutory prohibition. Drawing from Professor Frankel's extensive work, and from prior applications of fiduciary principles in congressional disciplinary actions and Executive Branch prosecutions of members of Congress for honest-services fraud, this Article argues that members of Congress and legislative staffers owe fiduciary-like duties of trust and confidence to a host of persons including the citizen-investors whom they serve, as well as the federal government, other members of Congress, and government officials outside of Congress who rely on their loyalty and integrity.³³ Based on these duties of entrustment, this Article concludes that congressional officials engage in deception, and therefore violate Rule 10b-5, if they trade securities on the basis of material nonpublic information obtained through congressional service.

A new statute explicitly prohibiting the offense of insider trading would be a very welcome development under the federal securities laws.³⁴ But almost all instances of real or hypothesized congressional insider trading can fit squarely within either the classical or misappropriation theory paradigms under Rule 10b-5. Given that it has the authority to investigate all instances of possible insider trading in securities, the SEC should be doing more to refute the mistaken view that there is some type of congressional exemption. Indeed, education, rather than prosecution, may be the SEC's most effective enforcement tool. Any legislative change should clarify insider trading law for everyone, and until that time, the current law – with its emphasis on duties of entrustment – works as well for congressional officials as it does for every other person who trades securities in our capital markets.

³¹ TAMAR FRANKEL, *FIDUCIARY LAW* (2011).

³² See TAMAR FRANKEL, *TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD* (2006); Tamar Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795 (1983).

³³ See *infra* Part III.A.

³⁴ See Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 183 (1991) (observing that the federal prohibition of insider trading “has been developed within the framework of federal securities fraud” and concluding that “the resulting case law contains logical as well as interpretive flaws”); Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881, 883, 889 (2010) (contending that “[t]he absence of a clear definition of insider trading under federal securities law has led to hundreds of decisions grappling with the issue” and that, without new legislation, “courts will continue to muddle through the tortuous path of Rule 10b-5 liability for insider trading”).

I. INSIDER TRADING AS A VIOLATION OF SECTION 10(b) AND RULE 10b-5

Almost twenty-five years ago, in the wake of Wall Street scandals involving Ivan Boesky and Michael Milken, among many others,³⁵ Congress responded to calls for an explicit statutory prohibition of insider trading and considered several specific proposals.³⁶ The Insider Trading Proscription Act of 1987, for example, would have amended the Exchange Act to prohibit the use of material nonpublic information to purchase or sell any security if a “person knows or recklessly disregards that such information has been obtained wrongfully, or that such purchase or sale would constitute a wrongful use of such information.”³⁷ Congress, however, ultimately decided against any explicit statutory prohibition because, in its view, “the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases, and . . . a statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law.”³⁸

The “court-drawn parameters of insider trading” that operate today have not changed much from those that engendered congressional confidence in the 1980s, nor has the SEC’s resolve to combat illegal insider trading diminished. Today, as in the 1980s, insider trading is usually prosecuted as a violation of Rule 10b-5 under either the classical or misappropriation theory.³⁹ To the extent that insider trading law has evolved, it has done so largely to expand

³⁵ See Daniel Hertzberg, *The Informant: How a Bookkeeper for Boesky Helped Bring Down Milken*, WALL. ST. J., Oct. 11, 1990, at A1 (recalling the government prosecution of Boesky, Milken, and Drexel Burnham).

³⁶ See Richard W. Painter et al., *Don’t Ask, Just Tell: Insider Trading After United States v. O’Hagan*, 84 VA. L. REV. 153, 200-02 (1998) (discussing the testimony and debates leading up to the Insider Trading Sanctions Act of 1984 (ITSA), Pub. L. No. 98-376, 98 Stat. 1264, and the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), Pub. L. No. 100-704, 102 Stat. 4677); *id.* at 218-28 (analyzing statutory proposals suggested by the ABA’s Task Force on the Regulation of Insider Trading as well as by a host of securities law scholars).

³⁷ The Insider Trading Proscriptions Act of 1987, S. 1380, 100th Cong. (1987), *reprinted in SEC Compromise Proposal on Insider Trading Legislation; Accompanying Letter, and Analysis by Ad Hoc Legislation Committee*, 19 Sec. Reg. & L. Rep (BNA) 1817 (Nov. 27, 1987). The statutory definition of “wrongful” extended to information that:

has been obtained by, or its use would constitute, directly or indirectly, (A) theft, bribery misrepresentation, espionage (through electronic or other means) or (B) conversion, misappropriation, or any other breach of a fiduciary duty, breach of any personal or other relationship of trust and confidence, or breach of any contractual or employment relationship.

Id.

³⁸ H.R. REP. NO. 100-910, at 11 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6048.

³⁹ See *United States v. O’Hagan*, 521 U.S. 642, 652 (1997) (“The two theories are complementary, each addressing efforts to capitalize on nonpublic information through the purchase or sale of securities.”).

these paradigms to encompass cases where material nonpublic information has been acquired or used improperly, even in instances where the trader or tipper had not been entrusted with information.⁴⁰ Moreover, as in the 1980s, the SEC continues to place a high priority on insider trading investigations and prosecutions. From 2001 through 2006, for example, the SEC's Division of Enforcement initiated more than 300 actions against more than 600 individuals and entities for alleged insider trading.⁴¹ Over that five-year time period, insider trading cases made up about seven to twelve percent of the SEC's filed caseload.⁴²

This Part of the Article is divided into three Sections. Section A recounts the judicial development of the classical and misappropriation theories of insider trading and, in so doing, highlights key cases involving persons (including several government officials) who were found liable for violating Rule 10b-5 because of their trading in securities based on material nonpublic information entrusted to them. Section B briefly examines an SEC rule which delineates specific circumstances giving rise to a "duty of trust or confidence" for purposes of the misappropriation theory. Section C discusses other obstacles frequently encountered by the government in prosecuting insider trading as a violation of Rule 10b-5.⁴³

A. *The Judicial Development of Insider Trading Law*

1. The Classical Theory

Prior to the Supreme Court's landmark decision in *Chiarella v. United States*,⁴⁴ lower courts and the SEC advocated an expansive view of Rule 10b-5 liability that required "anyone in possession of material inside information [to]

⁴⁰ For recent cases recognizing Rule 10b-5 liability for insider trading notwithstanding the absence of a fiduciary-like relationship between the trader and the issuer or the source of the information, see *SEC v. Dorozhko*, 574 F.3d 42, 51 (2d Cir. 2009) (holding that a computer hacker would be liable for insider trading under Rule 10b-5 if he obtained material nonpublic information through deceptive means); *SEC v. Cuban*, 634 F. Supp. 2d 713, 725 (N.D. Tex. 2009) (holding that a defendant in an arm's-length business relationship with securities issuer could be liable for insider trading under Rule 10b-5 if he traded securities in breach of a promise not to use issuer's material nonpublic information in a securities transaction), *vacated on other grounds*, 620 F.3d 551 (5th Cir. 2010). For scholarly critiques of these decisions, see sources cited *infra* note 96.

⁴¹ *Illegal Insider Trading: How Widespread Is the Problem and Is There Adequate Criminal Enforcement?: Hearing Before the H. Comm. on the Judiciary*, 109th Cong. 4 (2006) [hereinafter *Hearings on Insider Trading*] (testimony of Linda Thomsen, Director, SEC Division of Enforcement).

⁴² *Id.*

⁴³ Much of the background in Part I is based on the more extensive discussion in RALPH C. FERRARA, DONNA M. NAGY & HERBERT THOMAS, *FERRARA ON INSIDER TRADING AND THE WALL* §§ 2.01[1]-[3], 2.02[3], 2.02[6] (2010).

⁴⁴ 445 U.S. 222 (1980).

either disclose it to the investing public, or . . . abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.”⁴⁵ The majority in *Chiarella* found this “parity of information” rule too broad because it contradicted the common law doctrine that a person’s mere silence about material facts in a business transaction was not fraudulent in the absence of a duty to disclose.⁴⁶ In the Court’s view, a duty to disclose material facts “arises when one party has information ‘that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.’”⁴⁷ Accordingly, under *Chiarella*’s classical theory, a corporate insider’s silence about material nonpublic information in a securities transaction violates Rule 10b-5 because “a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.”⁴⁸

Three years after deciding *Chiarella*, the Court made considerable use of legal fictions to expand its classical theory beyond traditional insiders (namely, an issuer’s officers, directors, and employees) whose silence about material facts in securities transactions may have been (at least arguably) regarded as fraudulent under the common law.⁴⁹ In *Dirks v. SEC*,⁵⁰ the Court observed that Rule 10b-5’s obligation to disclose or abstain extended as well to temporary agents or “constructive insiders” of the securities issuer, such as lawyers, accountants or consultants, who “become fiduciaries” of the corporation’s shareholders because “they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.”⁵¹ The *Dirks* Court further extended the classical theory to trading by so-called tippees of insiders who convey the securities issuer’s confidential information in exchange for a personal benefit.⁵² As the Court explained, “a tippee *assumes* a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information . . . when the insider has breached his fiduciary duty to the

⁴⁵ SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968).

⁴⁶ *Chiarella*, 445 U.S. at 228 (“[O]ne who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so.”).

⁴⁷ *Id.* (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1977)).

⁴⁸ *Id.*

⁴⁹ *But see* A.C. Pritchard, *United States v. O’Hagan: Agency Law and Justice Powell’s Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 26 (1998) (contending that from a doctrinal perspective, the *Chiarella* Court’s invocation of the common law of deceit “is strained” because common law fraud required a showing of reliance (which would be impossible to show in open-market transactions on a stock exchange) and would not have recognized a fiduciary duty owed to prospective shareholders).

⁵⁰ 463 U.S. 646 (1983).

⁵¹ *Id.* at 655 n.14 (emphasis added).

⁵² *Id.* at 659-60.

shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.”⁵³ Thus, even though constructive insiders and tippees stand as strangers to the issuer’s shareholders, like traditional insiders, their Rule 10b-5 liability “is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction.”⁵⁴

Although the Court undoubtedly had in mind traditional insiders and temporary agents of the securities issuer (and their tippees) when it framed its classical theory of insider trading liability,⁵⁵ its holdings in *Chiarella* and *Dirks* should apply in the context of any fiduciary or other “special relationship” between a securities trader and the issuer’s shareholders.⁵⁶ Indeed, traditional insiders, constructive insiders, and tippees are hardly the only persons whose “silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b).”⁵⁷ In *Affiliated Ute Citizens v. United States*,⁵⁸ for instance, the Court held that two assistant bank managers, who had assumed a fiduciary-like duty to act on behalf of selling stockholders, violated Rule 10b-5 when they purchased stock from those sellers while remaining silent about material facts pertaining to the existence of a secondary market that had priced the stock substantially higher.⁵⁹ Moreover, courts, including

⁵³ *Id.* at 660 (emphasis added). *Dirks*’s discussion of tipper-tippee liability is discussed more extensively *infra* Part III.D.

⁵⁴ *United States v. Chiarella*, 445 U.S. 222, 230 (1980); *see Dirks*, 463 U.S. at 658 (“We reaffirm today that ‘[a] duty [to disclose] arises from the relationship between parties . . . and not merely from one’s ability to acquire information because of his position in the market.’” (alterations in original) (quoting *Chiarella*, 445 U.S. at 231 n.14)).

⁵⁵ *See* WILLIAM K.S. WANG & MARC I. STEINBERG, *INSIDER TRADING* § 5:2.1 (2d ed. 2008) (depicting a *Chiarella/Dirks* “classical special relationship triangle”).

⁵⁶ *Chiarella*, 445 U.S. at 246 (Blackmun, J., dissenting) (observing that the majority had predicated insider trading liability on a “special relationship akin to fiduciary duty” (internal quotation marks omitted)); *see also Dirks*, 463 U.S. at 656 n.15 (holding that the mere receipt of nonpublic information from an insider does not create a “special relationship” between the tippee and the issuer’s shareholders); *Chiarella*, 445 U.S. at 232-33 (emphasizing that petitioner did not owe securities sellers a disclosure duty because: “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. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.”).

⁵⁷ *Chiarella*, 445 U.S. at 230.

⁵⁸ 406 U.S. 128 (1972).

⁵⁹ *Id.* at 153 (“The individual defendants, in a distinct sense, were market makers This being so, they possessed the affirmative duty under . . . Rule [10b-5] to disclose this fact to the . . . sellers.”). In support of this holding, the *Affiliated Ute* Court cited *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970). *Affiliated Ute*, 406 U.S. at 153. The Second Circuit had held in *Chasins* that a broker-dealer’s “failure to inform the customer fully of its possible conflict of interest, in that it was a market maker in the securities which it strongly recommended for purchase by him, was an omission of material fact in violation of Rule 10b-5.” *Chasins*, 438 F.2d at 1172.

the Supreme Court, have held that anti-fraud provisions in the federal securities law prohibit “scalping” – that is, recommending the purchase of a security without disclosing personal ownership of that same security – in circumstances in which the recommender owes duties of trust and confidence to the recipients of the recommendation.⁶⁰ Thus, in the specific context of securities traded on the basis of material nonpublic information, *Chiarella* and *Dirks* affirmed a more general doctrine that Rule 10b-5 is violated whenever a person remains silent about material facts in breach of a fiduciary-like disclosure duty owed to the persons with whom he trades.⁶¹ This general doctrine should apply when congressional officials and other public fiduciaries trade securities on the basis of nonpublic government information.⁶²

2. The Misappropriation Theory

After years of acceptance by many federal courts and the SEC, the Supreme Court gave the misappropriation theory of insider trading its ringing endorsement in *United States v. O’Hagan*.⁶³ As the Court explained, the

⁶⁰ SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 181, 201 (1963) (holding that registered investment advisers engage in fraud and deceit under section 206 of the Investment Advisers Act when they recommend securities to clients without disclosing to them that the adviser also owned the recommended securities); see also *Zweig v. Hearst Corp.*, 594 F.2d 1261, 1268 (9th Cir. 1979) (“[O]rdinarily [columnists] have no duty to disclose facts about their personal financial affairs . . . [but] the defendant assumed those duties when, with knowledge of the stock’s market and an intent to gain personally, he encouraged purchases of the securities in the market.”); SEC v. Park, 99 F. Supp. 2d 889, 900 (N.D. Ill. 2000) (holding that an internet guru who operated a stock-picking and investment advice website owed fee-paying subscribers a duty of trust and confidence that could render his silence about his intention to sell a fraud in violation of Rule 10b-5). Although the Ninth Circuit decided *Zweig* prior to the Supreme Court’s decision in *Chiarella*, the SEC insists that its precedent is still valid because the columnist’s Rule 10b-5 disclosure obligation had been predicated on his relationship of trust and confidence with his readers. *Park*, 99 F. Supp. 2d at 899 (considering the SEC’s argument and concluding that “*Zweig* still seems to be good law”).

⁶¹ In fact, the *Chiarella* Court cited *Affiliated Ute* as authority for its classical theory of insider trading. *Chiarella*, 445 U.S. at 229; cf. *Moss v. Morgan Stanley Inc.*, 719 F.2d 5, 11 (2d Cir. 1983) (“[T]he Supreme Court has extended the ‘duty of disclosure’ requirement to nontraditional ‘insiders’ – persons who have no special access to corporate information but who do have a special relationship of ‘trust’ and ‘confidentiality’ with the issuer or seller of the securities.” (citing *Affiliated Ute*, 406 U.S. 128; *Capital Gains*, 375 U.S. 180)).

⁶² See *infra* Part III.A.1.b.

⁶³ 521 U.S. 642, 665 (1997). Prior to the Court’s decision in *O’Hagan*, the validity of the misappropriation theory had been accepted by the Second, Third, Seventh, and Ninth Circuits. See, e.g., SEC v. Cherif, 933 F.2d 403, 410 (7th Cir. 1991); SEC v. Clark, 915 F.2d 439, 449 (9th Cir. 1990); Rothberg v. Rosenbloom, 771 F.2d 818, 822 (3d Cir. 1985); *United States v. Newman*, 664 F.2d 12, 18 (2d Cir. 1981). The theory had been rejected by the Fourth Circuit in *United States v. Bryan*, 58 F.3d 933, 944 (4th Cir. 1995), and by the Eighth Circuit in *United States v. O’Hagan*, 92 F.3d 612, 620 (8th Cir. 1996), *rev’d*, 521

misappropriation theory extends Rule 10b-5 to outsiders who lack fiduciary connections with an issuer's shareholders, but who owe fiduciary-like duties to the source of the material nonpublic information used in the securities transaction. Accordingly, the misappropriation theory is premised "on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."⁶⁴

Based on the statutory text of section 10(b) of the Exchange Act, the Court in *O'Hagan* had little trouble affirming the jury's verdict that the defendant, who had been a partner in a national law firm, had violated Rule 10b-5 by secretly trading the securities of an acquisition target based on material nonpublic information that he had learned from his law firm and its client, which had been planning the hostile acquisition.⁶⁵ In the Court's view, "a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality," satisfies Rule 10b-5's deception requirement because such trading "defrauds the principal of the exclusive use of that information."⁶⁶ The Court observed that misappropriators "deal in deception. A fiduciary who [pretends] loyalty to the principal while secretly converting the principal's information for personal gain dupes or defrauds the principal."⁶⁷ The Court also found that this deception satisfies Rule 10b-5's "in connection with" requirement because "the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities."⁶⁸ However, "[b]ecause the deception essential to the misappropriation theory involves feigning fidelity to the source of the information," the Court acknowledged that there would be no liability under Rule 10b-5 "if the fiduciary discloses to the source that he plans to trade on the nonpublic information."⁶⁹

Although the *O'Hagan* Court based its holding on the text of the statute, the Court also grounded the misappropriation theory in the "congressional purposes underlying § 10(b)."⁷⁰ As the Court candidly acknowledged, the theory is "well tuned to an animating purpose of the Exchange Act: to ensure honest securities markets and thereby promote investor confidence."⁷¹ Here

U.S. 642 (1997).

⁶⁴ *O'Hagan*, 521 U.S. at 652.

⁶⁵ *Id.* at 647-48.

⁶⁶ *Id.* at 652.

⁶⁷ *Id.* at 653-54 (alteration in original) (citations and internal quotation marks omitted).

⁶⁸ *Id.* at 655-56.

⁶⁹ *Id.* at 655. Here the Court emphasized two additional points: first, despite disclosure, a "fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty;" and second, when a person owes a fiduciary-like duty to two entities, disclosure to one but not the other would not absolve misappropriation theory liability. *Id.* at 655 & n.7.

⁷⁰ *Id.* at 659.

⁷¹ *Id.* at 658.

the Court observed that while “informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law.”⁷² The SEC and Congress have also advanced these same policy arguments to justify rigorous federal regulation of insider trading.⁷³ Market integrity and investor confidence-based rationales have, however, generated a spirited debate among securities law scholars that has lasted for decades.⁷⁴

The Court in *O’Hagan* emphasized that the misappropriation theory “is limited to those who breach a recognized duty.”⁷⁵ But *O’Hagan*’s particular facts may have caused it to skimp a bit in describing the precise contours of the relationship that triggers the disclosure obligation essential to the theory. The defendant in *O’Hagan* was an attorney who clearly stood in a fiduciary relationship with both his law firm and its client.⁷⁶ Accordingly, the Court simply assumed that the defendant-attorney owed both his firm and its client a fiduciary duty that was breached when he used their information in securities trading without first informing them of his intention to do so.

Yet the Court in *O’Hagan* never implied – let alone stated – that a relationship had to be strictly a “fiduciary” one for a disclosure duty to attach under the misappropriation theory. Rather, reflecting the practice of lower courts applying the misappropriation theory,⁷⁷ the Court used the term “fiduciary duty” interchangeably with a “duty of trust and confidence.”⁷⁸ This

⁷² *Id.*

⁷³ See Selective Disclosure and Insider Trading, Exchange Act Release No. 42,259 [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,228, at 82,859 (proposed Dec. 20, 1999) [hereinafter SEC Proposing Release] (“We have long recognized that the fundamental unfairness of insider trading harms not only individual investors, but also the very foundations of our markets, by undermining investor confidence in the integrity of the markets.”); *infra* note 192 and accompanying text (quoting congressional statement that insider trading by temporary or constructive insiders “undermines confidence in the markets in the same manner as trading by corporate insiders”).

⁷⁴ For an extensive review of the vast scholarly literature on the detriments and benefits of insider trading, see 18 DONALD C. LANGEVOORT, INSIDER TRADING REGULATION ENFORCEMENT & PREVENTION §§ 1:2-1:6 (2010), and WANG & STEINBERG, *supra* note 55, §§ 2:1-2:4. A “protection of property rights” rationale for the federal insider trading prohibition is discussed *infra* note 284.

⁷⁵ *O’Hagan*, 521 U.S. at 666.

⁷⁶ *Id.* at 653 (discussing defendant’s breach of fiduciary duty to his law firm and its client).

⁷⁷ See, e.g., SEC v. Clark, 915 F.2d 439, 447 (9th Cir. 1990) (“The common-sense notion underlying the misappropriation theory is that one who misappropriates valuable information for his own benefit, in breach of a fiduciary or similar duty of trust and confidence, has surely committed fraud on the person or entity to whom that duty is owed.”).

⁷⁸ See *O’Hagan*, 521 U.S. at 653 (“[T]he indictment alleged that O’Hagan [traded

more flexible phraseology is consistent with the Court's insistence in *Chiarella* that common law disclosure duties were predicated on "a fiduciary or other similar relation of trust and confidence."⁷⁹ The *O'Hagan* Court's citation to the obligations reflected in sections 390 and 395 of the Restatement (Second) of Agency serves as further evidence that the Court envisioned "the recognized duty" as a broad one.⁸⁰

Both before and after *O'Hagan*, the SEC and most lower courts have been inclined to view the disclosure obligation at the heart of the misappropriation theory quite expansively. To be sure, the overwhelming number of decisions and settlements imposing Rule 10b-5 liability under the misappropriation theory involve relationships that are quintessentially fiduciary or their "functional equivalent,"⁸¹ such as employer-employee,⁸² principal-agent,⁸³

Pillsbury stock] in breach of a duty of trust and confidence he owed to his law firm . . . and to its client.").

⁷⁹ *Chiarella v. United States*, 445 U.S. 222, 228 (1980).

⁸⁰ See *O'Hagan*, 521 U.S. at 654-55; RESTATEMENT (SECOND) OF AGENCY § 390 (1958) ("[An agent has] a duty to deal fairly with the principal and to disclose to him all facts which the agent knows or should know would reasonably affect the principal's judgment."); *id.* § 395 ("[A]n agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury at the principal."); Pritchard, *supra* note 49, at 15 (contending that the Court in *O'Hagan* "breaks new ground in establishing a foundation for insider trading based on common law agency principles").

⁸¹ See *United States v. Chestman*, 947 F.2d 551, 567-68 (2d Cir. 1991) (en banc) (observing that "the common law has recognized that some associations are inherently fiduciary" including such "hornbook fiduciary relations [as] those existing between attorney and client, executor and heir, guardian and ward, principal and agent, trustee and trust beneficiary, and senior corporate official and shareholder" and concluding that disclosure duties also apply to their "function equivalent[s]"). The court in *Chestman* also observed that all of the Rule 10b-5 circuit precedents under the misappropriation theory at that time "involved egregious fiduciary breaches arising solely in the context of employer/employee associations." *Id.* at 567.

⁸² See, e.g., *Clark*, 915 F.2d at 453 ("[A]n employee's knowing misappropriation and use of his employer's material nonpublic information regarding its intention to acquire another firm constitutes a violation of § 10(b) and Rule 10b-5."); *Carpenter v. United States*, 791 F.2d 1024, 1026 (2d Cir. 1986) (holding that a reporter defrauded his *Wall Street Journal*-employer and violated Rule 10b-5 when he tipped stockbroker friends as to the contents of upcoming financial columns), *aff'd by a divided court*, 484 U.S. 19 (1987) (4-4 decision); *SEC v. Musella*, 578 F. Supp. 425, 439 (S.D.N.Y. 1984) (stating that law firm's office services manager breached duty to law firm and law firm's clients by tipping material nonpublic information he learned during employment), *aff'd*, 898 F.2d 138 (2d Cir. 1990).

⁸³ See, e.g., *SEC v. Materia*, 745 F.2d 197, 199 (2d Cir. 1984) (holding an employee of a financial printer liable under Rule 10b-5 for tipping information the printing company had acquired in confidence from its clients); *United States v. Newman*, 664 F.2d 12, 17 (2d Cir. 1981) (holding that employees at two investment banks violated Rule 10b-5 when they

attorney-client,⁸⁴ and doctor-patient.⁸⁵ But insider trading cases prosecuted under the misappropriation theory sometimes fall outside of these well-recognized categories and courts must then engage in ad hoc inquiries to determine whether the trader (or tipper) and the source of the information stand in a relationship of trust and confidence that renders the failure to disclose the use of material nonpublic information a fraud on the source in violation of Rule 10b-5.

In determining whether a professional, social, or familial relationship is one of trust and confidence for purposes of the misappropriation theory, courts generally look to the “reasonable and legitimate” expectations of the parties and question whether those parties had “a history or practice of sharing business confidences, [and whether] those confidences were generally maintained.”⁸⁶ More controversially, courts have also recognized a relationship of trust and confidence when the trader or tipper has “expressly agreed” to keep the source’s information confidential.⁸⁷ Based on such ad hoc inquiries, Rule 10b-5 liability has been imposed in cases involving: family members who traded on (or tipped) information misappropriated from their spouses and relatives;⁸⁸ participants in private placements who traded

tipped material nonpublic information that had been entrusted to their employer by clients of the banks).

⁸⁴ See, e.g., *O’Hagan*, 521 U.S. at 653; *United States v. Grossman* 843 F.2d 78, 84 (2d Cir. 1988) (affirming conviction under Rule 10b-5 where associate at law firm both traded on the basis of confidential client information and tipped relatives who subsequently traded).

⁸⁵ See, e.g., *United States v. Willis*, 778 F. Supp. 205, 209 (S.D.N.Y. 1991) (denying psychiatrist’s motion to dismiss insider trading indictment because “[t]he relationship between a psychiatrist and patient has all the characteristics of what the [Second Circuit] calls a ‘paradigmatic fiduciary relationship’” (quoting *Chestman*, 947 F.2d at 569)).

⁸⁶ *SEC v. Yun*, 327 F.3d 1263, 1272-73 (11th Cir. 2003).

⁸⁷ See, e.g., *SEC v. Nothern*, 598 F. Supp. 2d 167, 175 (D. Mass. 2009) (holding that the SEC’s allegation that tipper had “expressly agreed to maintain the confidentiality of . . . information is sufficient to state a claim that he had a similar relationship of trust and confidence” (internal quotation marks omitted)); *SEC v. Lyon*, 529 F. Supp. 2d 444, 452 (S.D.N.Y. 2008) (refusing to dismiss charges of insider trading because the SEC alleged specific facts evidencing that defendant had expressly agreed to keep information confidential). For contrary conclusions reached by courts and commentators, see *infra* notes 114, 121-128 and accompanying text.

⁸⁸ See *SEC v. Rocklage*, 470 F.3d 1, 12 (1st Cir. 2006) (stating that the SEC could show that wife deceived husband when she allowed him to share business confidences without informing him of a pre-existing agreement with her brother to share any significant information about the husband’s company); *Yun*, 327 F.3d at 1273-74 (“[T]he SEC provided sufficient evidence both that an agreement of confidentiality and a history or pattern of sharing and keeping of business confidences existed between [husband and wife].”); *United States v. Reed*, 601 F. Supp. 685, 718 (S.D.N.Y. 1985) (holding that government may prove at trial “that Reed and his father were bound by an agreement or understanding of confidentiality, express or implied, or that some regular pattern of behavior by defendant

securities in the public markets based on the confidential information to which they were given access;⁸⁹ an electrician who traded on information that he overheard while at a company repairing its wiring;⁹⁰ a member of a business roundtable who traded on information conveyed by a fellow member;⁹¹ a businessman who traded on information entrusted to him by his business partner;⁹² a bank that traded corporate bonds based on nonpublic information obtained through service on six bankruptcy creditors' committees;⁹³ a juror who tipped confidential information obtained from his service on a grand jury;⁹⁴ and a government affairs consultant who tipped information that had been subject to a news embargo by the Treasury Department.⁹⁵ To be sure, several securities law scholars (including this Author) have criticized some of these precedents for stretching too far the relationship of trust and confidence parameters that were drawn by the Court in *Chiarella*, *Dirks*, and *O'Hagan*.⁹⁶

and his father generated on the part of those two men a justifiable expectation of confidentiality and fidelity”), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985); LANGEVOORT, *supra* note 74, § 11:8 n.14 (citing SEC settlements in “gray areas” of liability such as those involving alleged insider trading by in-laws and a live-in non-marital partner). *But see infra* notes 109-113 and accompanying text.

⁸⁹ See *Lyon*, 529 F. Supp. 2d at 452 (concluding that the SEC’s complaint “plausibly support[s] its claim that a confidential relationship arose between defendants and those four PIPE issuers”); FERRARA ET AL., *supra* note 43, § 2.08[4] (discussing SEC settlements imposing Rule 10b-5 liability in the context of PIPE (private investment in public equity) transactions). *But see infra* notes 124-128 and accompanying text.

⁹⁰ SEC v. Falbo, 14 F. Supp. 2d 508, 522-24 (S.D.N.Y. 1998) (holding that although he was not a traditional fiduciary, an electrical contractor nonetheless was placed “in a position of trust and confidence” that he violated when he “used for personal benefit information obtained during the course of his association”).

⁹¹ SEC v. Kirch, 263 F. Supp. 2d 1144, 1150 (N.D. Ill. 2003) (concluding that roundtable members had an express, unwritten policy of keeping shared information confidential and thus owed a duty of trust and confidence to each other). *But see infra* note 114.

⁹² SEC v. Peters, 735 F. Supp. 1505, 1521 (D. Kan. 1990) (holding that the “partnership expected that all business matters of each partner would be held in trust and confidence”), *rev'd on other grounds*, 978 F.2d 1162 (10th Cir. 1992).

⁹³ Barclays Bank PLC, Litigation Release No. 20132, 90 SEC Docket 1999 (May 30, 2007) (announcing settlement whereby defendant agreed to pay \$10.9 million to settle charges of insider trading).

⁹⁴ See John Herzfeld, *Crime: Grand Juror Sentenced to Prison for Leaks to Insider Trading Ring*, 38 Sec. Reg. & L. Rep. (BNA) No. 49, at 2098 (Dec. 18, 2006) (reporting that a former postal worker, who had been serving on a grand jury investigating Bristol-Myers, pleaded guilty to conspiracy, insider trading, and criminal contempt for tipping information about that probe to two former employees of Goldman Sachs).

⁹⁵ Davis, Litigation Release No. 18322 (Sept. 4, 2003), available at <http://www.sec.gov/litigation/litreleases/lr18322.htm> (announcing guilty plea and civil settlement with the SEC); see also SEC v. Nothorn, 598 F. Supp. 2d 167, 173 (D. Mass. 2009) (denying summary judgment motion brought by one of the consultant’s tippees).

⁹⁶ See Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*,

But the fact remains that the SEC and the DOJ have been consistent, and for the most part successful, in advancing a strikingly broad view as to what it means to be entrusted with material nonpublic information for purposes of the Rule 10b-5 insider trading prohibition.

Misappropriation theory cases involving “hornbook fiduciary relations”⁹⁷ such as employment, including government employment, typically do not involve the same ad hoc focus on the source’s “reasonable and legitimate” expectations of confidentiality that is the norm in cases involving family members, businesspersons, and the like. Instead, as with other employer-employee cases,⁹⁸ in insider trading prosecutions brought against government officials, courts simply assume without question that those officials breached fiduciary duties when they used material nonpublic information obtained through government service for securities trading purposes, or when they tipped others who used that information to trade.⁹⁹ Notable Rule 10b-5 prosecutions have involved securities trading or tipping by federal officials at the Federal Bureau of Investigation (FBI),¹⁰⁰ the Federal Reserve,¹⁰¹ the

94 IOWA L. REV. 1315, 1363-64 (2009) (arguing that several recent cases and SEC settlements reflect an evolving view that the offense of insider trading involves the wrongful use of material nonpublic information regardless of whether the trader or tipper breaches a fiduciary-like duty owed to the issuer’s shareholders or the source of the information); *see also* Amended Brief of Amici Curiae in Support of Defendant’s Motion to Dismiss at 1-2, SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009) (No. 3:08-cv-02050), 2009 WL 1257407 [hereinafter Amended Brief of Amici Curiae] (submitted by Professors Allen Ferrell, Stephen Bainbridge, Alan R. Bromberg, M. Todd Henderson, and Jonathan R. Macey, arguing that “[u]nder both state and federal common law, a confidentiality agreement alone creates only an obligation to maintain the secrecy of the information, not a fiduciary or fiduciary-like duty to act loyally to the source of the information”); STEPHEN M. BAINBRIDGE, SECURITIES LAW: INSIDER TRADING 83 n.33 (2d ed. 2007) (criticizing the results-oriented nature of the “trust and confidence” phraseology because “[i]f a court wishes to impose liability, it need simply conclude that the relationship in question involves trust and confidence, even though the relationship bears no resemblance to those in which fiduciary-like duties are normally imposed”).

⁹⁷ *See* SEC v. Chestman, 947 F.2d 551, 567-68 (2d Cir. 1991) (en banc).

⁹⁸ *See* sources cited in *supra* note 82.

⁹⁹ Many federal agencies and executive departments also operate under specific statutes and rules prohibiting officials from using and/or disseminating nonpublic government information for nongovernmental purposes. *See* PAINTER, *supra* note 12, at 63-65 (discussing the U.S. Department of the Treasury and observing that “Congress, for over 200 years, has been adding piecemeal statutory provisions in response to conflicts of interest in particular agencies”).

¹⁰⁰ *United States v. Royer*, 549 F.3d 886, 890 (2d Cir. 2008) (affirming former FBI special agent’s Rule 10b-5 conviction and six year prison sentence for tipping others who traded securities based on material nonpublic information obtained from law enforcement databases).

¹⁰¹ *See* Blyth & Co., 43 S.E.C. 1037, 1039 (1969) (holding brokerage firm employees liable under Rule 10b-5 for trading on material nonpublic information about an upcoming

Department of the Navy,¹⁰² and the Comptroller of the Currency.¹⁰³ State officials have also been prosecuted under Rule 10b-5 for trading securities on the basis of nonpublic information obtained through government service.¹⁰⁴ Other decisions have held government officials or their tippees liable for defrauding the government when entrusted information was misappropriated for personal profit in the securities market,¹⁰⁵ the commodities market,¹⁰⁶ or in

issuance of government securities that had been tipped to them by a manager of the Bond and Custody Department of the Federal Reserve Bank of Philadelphia); *Shift by U.S. in Insider Case*, N.Y. TIMES, Aug. 30, 1989, at D12 (reporting that Robert Rough, a former director of the New York Federal Reserve Bank, admitted that he regularly disclosed nonpublic information about the Fed's discount rate to a securities brokerage firm, and that in exchange for Rough's plea to one count of bank fraud, "the Government agreed to drop six other counts, including insider trading and . . . agreed to recommend a prison sentence of less than a year."); see also *Fed Ex-Official Gets 6 Months*, N.Y. TIMES, Sept. 14, 1989, at D7 (reporting Rough's sentence of six months in prison and 200 hours of community service during two years of probation).

¹⁰² Saunders, Litigation Release No. 9744, 26 SEC Docket 75 (Sept. 2, 1992) (announcing guilty plea and the settlement of civil charges in Rule 10b-5 case against civilian employed by Navy who had purchased shares in a company that was about to be awarded a government contract); Mills, Litigation Release No. 11877, 41 SEC Docket 1257 (Sept. 28, 1988) (discussing an independent consultant hired by the Navy who settled Rule 10b-5 charges that he purchased shares of a company based on the material nonpublic information that the company's bid for a Navy contract was favored over its competitor's bid).

¹⁰³ Acree, Litigation Release No. 14231, 57 SEC Docket 1579 (Sept. 13, 1994) (discussing a former employee of the Office of the Comptroller of the Currency who settled Rule 10b-5 charges that he traded in securities of several bank holding companies while in possession of material nonpublic information which he misappropriated from the OCC).

¹⁰⁴ *United States v. Bryan*, 58 F.3d 933, 936 (4th Cir. 1995) (reversing Rule 10b-5 conviction of the former Director of the state-owned West Virginia Lottery who had used material nonpublic information to purchase securities in issuers about to be awarded government contracts, but affirming the Director's conviction under the federal wire fraud statute for the same conduct). The Fourth Circuit's finding that Rule 10b-5 liability could not be premised on the misappropriation theory was itself overturned with the Supreme Court's decision in *O'Hagan*, 521 U.S. 642, 650 (1997). For additional discussion of the Fourth Circuit's wire fraud holding in *Bryan*, see *infra* notes 277-280 and accompanying text. For a related prosecution of a second defendant, see *United States v. ReBrook*, 842 F. Supp. 891, 892 (S.D. W. Va. 1993) (affirming jury verdict finding violations of Rule 10b-5 and the federal wire fraud statute by an attorney with the state-owned West Virginia Lottery who had used material nonpublic information to purchase securities in issuers who were about to be awarded government contracts), *aff'd in part, rev'd in part*, 58 F.3d 961, 963 (4th Cir. 1995) (affirming wire fraud ruling but reversing Rule 10b-5 ruling that had been premised on the misappropriation theory).

¹⁰⁵ *United States v. Peltz*, 433 F.2d 48, 49 (2d Cir. 1970) (affirming defendant's conviction for "conspir[ing] with others, including an employee of the SEC, to obtain confidential inside information about matters under consideration by the Commission and use such information for private profit"). For a fascinating discussion of a dismissed

real estate transactions.¹⁰⁷ Accordingly, at least at first blush, insider trading by members of Congress and legislative staffers would seem to fit squarely within these other government official precedents.¹⁰⁸

B. *SEC Rule 10b5-2*

As the foregoing has explained, when confronted with non-traditional fiduciary relationships, the SEC and most lower courts have taken an expansive view of the circumstances under which a securities trader (or tipper) and the source of material nonpublic information can be said to be in a relationship of trust and confidence for purposes of the misappropriation theory. The Second Circuit's *en banc* decision in *United States v. Chestman*¹⁰⁹ constitutes a notable exception. The *Chestman* court reversed the defendant's conviction under Rule 10b-5 because, in the court's view, the government did not sustain its burden of proving a sufficient fiduciary-like relationship between the tipper and the source of the information.¹¹⁰ Although the tipper was married to the source, and the information was imparted in confidence, the Second Circuit reasoned that "marriage does not, without more, create a fiduciary relationship"¹¹¹ and that "a fiduciary duty cannot be imposed

conspiracy prosecution against a law clerk to Supreme Court Justice Joseph McKenna for allegedly tipping others who traded securities based on information pertaining to an unreleased decision, see John B. Owens, *The Clerk, the Thief, His Life as a Baker: Ashton Embry and the Supreme Court Leak Scandal of 1919*, 95 NW. U. L. REV. 271, 272 (2000). As Owens explains it, the prosecution was dismissed even though an indictment against the law clerk had been upheld by the Court of Appeals of the District of Columbia and a writ of certiorari had been denied by the Supreme Court. See *id.* at 297-98 (citing *Embry v. United States*, 257 U.S. 655 (1921)). Owens maintains that the DOJ's official files "remain eerily quiet on the subject, containing no notes or memoranda explaining why the U.S. Attorney dismissed the case." *Id.* at 297.

¹⁰⁶ *Haas v. Henkel*, 216 U.S. 462, 472 (1910); *Peckham v. Henkel*, 216 U.S. 483, 484 (1910); *Price v. Henkel*, 216 U.S. 488, 494 (1910). The *Haas* Court observed that the conspiracy was to obtain crop reports from a statistician in the Department of Agriculture in advance of general publicity and to use such information in speculating upon the cotton market, and thereby defraud the United States by defeating, obstructing and impairing it in the exercise of its governmental function in the regular and official duty of publicly promulgating fair, impartial and accurate reports concerning the cotton crop.

Haas, 216 U.S. at 478.

¹⁰⁷ *United States v. Keane*, 522 F.2d 534, 561 (7th Cir. 1975) (affirming conviction of city councilman under conspiracy and mail fraud statutes for conduct including the purchase of tax delinquent properties based on nonpublic information).

¹⁰⁸ See *infra* Part III.A.2.a.

¹⁰⁹ *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (*en banc*).

¹¹⁰ *Id.* at 554.

¹¹¹ *Id.* at 568. The court reasoned that "[a] similar relationship of trust and confidence . . . must be the functional equivalent of a fiduciary relationship." *Id.* (internal quotation marks omitted).

unilaterally by entrusting a person with confidential information.”¹¹² Rather, as the Second Circuit saw it:

A fiduciary relationship involves discretionary authority and dependency: One person depends on another – the fiduciary – to serve his interests. In relying on a fiduciary to act for his benefit, the beneficiary of the relation may entrust the fiduciary with custody over property of one sort or another. Because the fiduciary obtains access to this property to serve the ends of the fiduciary relationship, he becomes duty-bound not to appropriate the property for his own use. . . . These characteristics represent the measure of the paradigmatic fiduciary relationship. A similar relationship of trust and confidence consequently must share these qualities.¹¹³

Other courts have emphasized the *Chestman* court’s characterization of a fiduciary¹¹⁴ as one who acts for “the benefit of another person, as to whom he stands in a relation implying and necessitating great confidence and trust on the one part and a high degree of good faith on the other part.”¹¹⁵

The SEC promulgated Rule 10b5-2 in direct response to what it viewed as *Chestman*’s unduly narrow parameters¹¹⁶ and its failure to “sufficiently protect investors and the securities markets from the misappropriation and resulting misuse of inside information.”¹¹⁷ The rule bears the caption, “Duties of trust or

¹¹² *Id.* at 567.

¹¹³ *Id.* at 569.

¹¹⁴ *See, e.g.,* *United States v. Falcone*, 257 F.3d 226, 234-35 (2d Cir. 2001) (“[Fiduciary] relationships are marked by the fact that the party in whom confidence is reposed has entered into a relationship in which he or she acts to serve the interests of the party entrusting him or her with such information.” (citing *Chestman*, 947 F.2d at 568-69)). For cases citing *Chestman* as a reason for declining to find a fiduciary-like relationship for purposes of the misappropriation theory, see *United States v. Cassese*, 273 F. Supp. 2d 481, 485 (S.D.N.Y. 2003) (emphasizing that the business competitors were “not inherent fiduciaries, but rather potential arms-length business partners . . . [who] did not have a long-standing relationship or . . . regularly shared confidences,” and concluding that “[t]his is very far from a relationship marked by ‘de facto control’ and ‘dominance’ or entailing ‘discretionary authority and dependency’” (quoting *Chestman*, 947 F.2d at 568-69)), and *United States v. Kim*, 184 F. Supp. 2d 1006, 1008-09 (N.D. Cal. 2002) (holding that a member of the Young Presidents Association, a national organization of company presidents under the age of fifty, did not owe a duty of trust or confidence to fellow club member, notwithstanding the club’s written requirement that all members must comply with a confidentiality agreement).

¹¹⁵ *Chestman*, 947 F.2d at 568-69.

¹¹⁶ *See* SEC Proposing Release, *supra* note 73, at 82,863 (“[T]he *Chestman* majority’s approach does not fully recognize the degree to which parties to close family and personal relationships have reasonable and legitimate expectations of confidentiality in their communications.”).

¹¹⁷ *See id.*

confidence in misappropriation insider trading cases,”¹¹⁸ and as its preliminary note explains that the rule provides a non-exclusive list of three situations in which a person has “a duty of trust or confidence” for purposes of the misappropriation theory.¹¹⁹ The three situations enumerated in Rule 10b5-2(b) include:

- (1) Whenever a person agrees to maintain [that] information in confidence;
- (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or
- (3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling; *provided*, however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential¹²⁰

Accordingly, had Rule 10b5-2(b)(3) been in place at the time of the *Chestman* defendant’s alleged violations, it may have changed the result.

But it is the first subsection of Rule 10b5-2(b) that has received the bulk of attention from commentators and courts. Several securities law scholars (this Author among them) have questioned whether the SEC can expand the misappropriation theory to encompass the mere breach of a confidentiality agreement notwithstanding the absence of a fiduciary or similar relationship of trust and confidence between the trader and the information’s source.¹²¹ Agreements to maintain the confidentiality of information may be entered into by persons owing duties of trust and confidence to the source (and may thus confirm a duty otherwise inherent in that relationship). But confidentiality

¹¹⁸ SEC Rule 10b5-2, 17 C.F.R. § 240.10b5-2 (2010).

¹¹⁹ *Id.* at Preliminary Note.

¹²⁰ *Id.* § 240.10b5-2(b)(1)-(3).

¹²¹ See Nagy, *supra* note 96, at 1357-64 (questioning the validity of Rule 10b5-2(b)(1) and observing that the rule phrases the requisite duty in the disjunctive (trust or confidence) whereas the Supreme Court has always referred to the duty in the conjunctive (trust and confidence)); see also Amended Brief of Amici Curiae, *supra* note 96, at 1-2 (arguing for the invalidity of Rule 10b5-2 insofar as it provides for liability under the misappropriation theory based on the mere breach of a confidentiality agreement); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1422 (2002) (“[E]xtending securities liability to any relationship where ‘a person agrees to maintain information in confidence’ extends the boundaries well beyond fiduciary relationships.” (quoting SEC Rule 10b5-2, 17 C.F.R. § 240.10b5-2)).

agreements may also arise in the course of an arm's-length business transaction without any concomitant obligation of trust or loyalty.¹²²

Although several courts have discussed Rule 10b5-2(b)(1) in their decisions under the misappropriation theory,¹²³ the court in *SEC v. Cuban*¹²⁴ was the first to directly confront that rule's validity. In so doing, the court concluded that "an express or implied promise merely to keep information confidential" does not, standing alone, create a duty of disclosure for purposes of the misappropriation theory.¹²⁵ It thus held Rule 10b5-2(b)(1) invalid to the extent that it purports to create such a duty.¹²⁶ But the court also recognized that "a duty sufficient to support liability under the misappropriation theory can arise by agreement absent a preexisting fiduciary or fiduciary-like relationship," provided that the agreement goes beyond the mere promise of confidentiality to "impose on the party who receives the information the legal duty to refrain from trading on or otherwise using the information for personal gain."¹²⁷ In the court's view, only then is a non-fiduciary's "subsequent undisclosed use of the information for securities trading purposes . . . deceptive under § 10(b) and Rule 10b-5."¹²⁸ The Fifth Circuit did nothing to disturb the district court's holding on appeal, but it nonetheless vacated the judgment for dismissal and remanded the case. On its reading of the SEC's complaint, there was "more than a plausible basis" to find that the defendant had promised not to use the confidential information that had been conveyed to him.¹²⁹

C. *Other Obstacles in Prosecuting Insider Trading Cases*

In many insider trading cases, establishing a fiduciary-like relationship of trust and confidence between the defendant and the issuer's shareholders or the source of the information may be the easiest step in the government's prosecution under Rule 10b-5. The government, however, may encounter other obstacles in establishing all of the elements necessary to prove that Rule 10b-5 has been violated. In a civil prosecution, the SEC must establish these

¹²² See Nagy, *supra* note 96, at 1362 ("[A]n agreement not to share information with third parties is analytically distinct from a fiduciary obligation not to take advantage of that information in one's personal securities trading over a stock exchange.").

¹²³ See, e.g., *SEC v. Nothern*, 598 F. Supp. 2d 167, 175 (D. Mass. 2009); Nagy, *supra* note 96, at 1363 n.274 (citing cases discussing Rule 10b5-2(b)(1) in misappropriation theory decisions).

¹²⁴ *SEC v. Cuban*, 634 F. Supp. 2d 713 (N.D. Tex. 2009), *vacated and remanded*, 620 F.3d 551 (5th Cir. 2010).

¹²⁵ *Id.* at 725 (stating that there must be an accompanying promise not to use "the information for personal gain").

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ *Id.* at 726.

¹²⁹ *SEC v. Cuban*, 620 F.3d 551, 557 (5th Cir. 2010).

elements by a preponderance of the evidence, whereas in a criminal prosecution, the DOJ must prove its case beyond a reasonable doubt.¹³⁰

Regardless of whether an insider trading case is prosecuted under the classical or the misappropriation theory, the government must prove that the information at issue was both nonpublic and material. Information is considered “nonpublic” if it is not generally available to the investing public. That is, information becomes public when it has been disclosed “to achieve a broad dissemination to the investing public generally”¹³¹ or when, although it is known only by a few persons, their trading on the basis of it “has caused the information to be fully impounded into the price of the particular stock.”¹³² These tests, however, have been criticized for their failure “to provide businesses with certainty, the law with clarity, the market with confidence, and the layman with guidance.”¹³³ Information is considered “material” if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision.¹³⁴ Moreover, when information is “soft” or contingent, its materiality is to be judged by “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 facts and circumstances.¹³⁵ Yet, notwithstanding the breadth of these definitions, both courts and the SEC have acknowledged that securities traders generally, and analysts in particular, should remain free to “piece seemingly inconsequential data together with public information into a mosaic”¹³⁶ which only becomes “material after the bits and pieces are assembled into one picture.”¹³⁷ Whether a nonpublic fact is material or whether it is merely inconsequential data contributing to a mosaic is often a difficult question.¹³⁸

¹³⁰ See DONNA M. NAGY, RICHARD W. PAINTER & MARGARET V. SACHS, *SECURITIES LITIGATION AND ENFORCEMENT: CASES AND MATERIALS* 13 (2d ed. 2008).

¹³¹ *Dirks v. SEC*, 463 U.S. 646, 653 n.12 (1983).

¹³² *United States v. Libera*, 989 F.2d 596, 601 (2d Cir. 1993).

¹³³ J. Scott Colesanti, “*We’ll Know It When We Can’t Hear It*”: A Call for a Non-Pornography Test Approach to Recognizing Non-Public Information, 35 *HOFSTRA L. REV.* 539, 539 (2006).

¹³⁴ *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988).

¹³⁵ *Id.* at 238 (quoting *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc)).

¹³⁶ *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 165 (2d Cir. 1980).

¹³⁷ *Dirks*, Exchange Act Release No. 17480, 21 SEC Docket 1401, 1409 (Jan. 22, 1981) (“We have long recognized that an analyst may utilize nonpublic, inside information which in itself is immaterial in order to fill in interstices in analysis. That process is legitimate” (internal quotation marks omitted)), *aff’d*, 681 F.2d 824 (D.C. Cir. 1982), *rev’d on other grounds*, 463 U.S. 646 (1983).

¹³⁸ See Joan Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 *AM. U. L. REV.* 1131, 1138-39 (2003) (“The facial simplicity of the basic legal standard governing materiality masks the complexities encountered by transaction planners, litigants, the SEC, the [DOJ], and courts in interpreting and applying that standard.

Rule 10b-5 cases prosecuted under the misappropriation theory present their own unique challenges. Because the theory is premised on a defendant's use of material nonpublic information that had been entrusted to him by its source, the government has the burden of establishing that the defendant actually used that information in making his decision to trade.¹³⁹ Often, defendants in insider trading cases will deny their awareness of material nonpublic information at the time of a securities trade¹⁴⁰ or defendants will claim that their reason for trading was completely unrelated to the information in their possession.¹⁴¹ Such misappropriation cases rarely involve a smoking gun.¹⁴² Accordingly, the government generally must rely on circumstantial evidence to establish that the defendant was aware of material nonpublic information and then used that information in a securities transaction for personal profit.¹⁴³

Finally, in all insider trading cases, the government must prove that the defendant acted with scienter, a "mental state embracing intent to deceive, manipulate or defraud."¹⁴⁴ Assuming that the government has established a disclosure duty based on a fiduciary-like relationship of trust and confidence, the additional element of scienter is generally established through evidence showing that the defendant knew, or was reckless in not knowing, that the information on which he was trading was both material and nonpublic.¹⁴⁵

The interpretation and application of the materiality standard are highly fact-dependent and do not always produce predictable or certain planning options or judicial results.”)

¹³⁹ Although SEC Rule 10b5-1 specifies that a securities transaction is made “on the basis of material nonpublic information about that security” if the person making the purchase or sale was “aware” of that information at the time of the trade (subject to three narrow affirmative defenses), 17 C.F.R. § 240.10b5-1 (2010), it is unlikely that the Rule’s presumption of use from possession could apply where the Rule 10b-5 violation is premised on the defendant’s use of material nonpublic information under the misappropriation theory. See Donna M. Nagy, *The “Possession vs. Use” Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never Be Golden*, 67 U. CIN. L. REV. 1129, 1147 & n.88 (1999) (arguing that without proof of the defendant’s use of information, there would be no misappropriation and thus no concomitant duty to disclose under Rule 10b-5).

¹⁴⁰ See Frank C. Razzano, *Insider Trading . . . or Not? Lessons Learned From an Acquittal*, 15 BUS. L. TODAY 34, 39 (2006) (discussing the “leakage” defense for denying knowledge of nonpublic information).

¹⁴¹ See, e.g., *SEC v. Alder*, 137 F.3d 1325, 1328 (11th Cir. 1998) (discussing defendant who claimed his sales of stock were preplanned and not based on his use of material nonpublic information).

¹⁴² See *Hearings on Insider Trading*, *supra* note 41, at 5 (discussing the inability to take further action because of a lack of necessary evidence).

¹⁴³ See Razzano, *supra* note 140, at 41 (acknowledging that “ambiguous circumstances and trading may often be transformed by the prosecution into circumstantial evidence of insider trading,” but emphasizing that “[t]he job of defense counsel is to take those same circumstances and present the jury with an equally plausible and believable story consistent with innocence”).

¹⁴⁴ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

¹⁴⁵ NAGY ET AL., *supra* note 130, at 552.

Proof that the defendant was merely negligent in failing to recognize that the information was material and nonpublic is not sufficient for liability to attach under Rule 10b-5.¹⁴⁶

II. THE STOP TRADING ON CONGRESSIONAL KNOWLEDGE (STOCK) ACT

Part III of this Article makes an explicit and extensive case for why insider trading by members of Congress and legislative staffers breaches duties of trust and confidence and why it is thus already illegal under the classical and misappropriation theories of Rule 10b-5 liability. Before making that case, however, this Part briefly examines proposed legislation and highlights some of its shortcomings.

A. *The Proposed Legislation*

Convinced that current law contains an “insider trading loophole” for congressional officials¹⁴⁷ and that it is thus “perfectly legal to profit from information obtained within the Congress,”¹⁴⁸ U.S. Representatives Brian Baird (D-Wash.) and Louise M. Slaughter (D-N.Y.) introduced legislation in 2006 to “prohibit Members and employees of Congress from profiting from nonpublic information they obtain in their official positions.”¹⁴⁹ Representative Slaughter’s press release announcing the legislation posits this specific example:

Congressman B learns that the Chairman of the Appropriations Committee has decided to provide a multi-million dollar defense contract for Company A in the Defense Appropriations bill. This information has not been released to the public, but will almost certainly drive Company A’s stock price up when it becomes public knowledge. Congressman B buys stock in Company A. **THIS IS NOT ILLEGAL UNDER CURRENT INSIDER TRADING LAWS, AND IS WHAT THE LEGISLATION ADDRESSES.**¹⁵⁰

¹⁴⁶ *See id.*

¹⁴⁷ *Preventing Unfair Trading by Government Officials: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Fin. Servs.*, 111th Cong. 4 (2009) [hereinafter *Hearings on Unfair Trading*] (statement of Rep. Louise Slaughter).

¹⁴⁸ *Rep. Baird, Slaughter Seek Capitol Hill Insider Trading Ban*, U.S. FED. NEWS, Mar. 28, 2006 [hereinafter *Baird March 2006 Press Release*], available at 2006 WLNR 5302281.

¹⁴⁹ *Id.*

¹⁵⁰ Press Release, Rep. Louise M. Slaughter (D-N.Y.), STOCK Act Fact Check, CONGRESSWOMAN LOUISE M. SLAUGHTER (Mar. 3, 2006), http://www.louise.house.gov/index.php?option=com_content&task=view&id=433&Itemid=106 [hereinafter *Slaughter Fact Check*] (on file with author). The press release observes that “[j]ust as anyone else, Members of Congress and staffers are subject to current insider trading laws,” but then it states that “current insider trading laws do not apply to nonpublic information about current or upcoming congressional activity.” *Id.*

This bolded legal conclusion appears to be based on what this Article will show is the faulty premise that “members of Congress and their staff do not owe a duty of confidentiality to Congress.”¹⁵¹

The original version of the Stop Trading on Congressional Knowledge Act, dubbed the STOCK Act,¹⁵² had fourteen additional co-sponsors in the House and was referred out to several Committees, but the bill failed to advance.¹⁵³ Representatives Baird and Slaughter reintroduced a similar bill in 2007¹⁵⁴ and again most recently in January 2009.¹⁵⁵ The STOCK Act was also the subject of a one-day hearing in July 2009 before the Subcommittee on Oversight and Investigations of the House Committee on Financial Services.¹⁵⁶

The latest version of the STOCK Act, according to its co-authors, would “bar members of Congress and their staffs from buying and trading stocks using nonpublic information they obtain through their positions.”¹⁵⁷ The legislation seeks to create this “bar” by amending section 10 of the Exchange Act to include a new subsection 10(c):

(c) NONPUBLIC INFORMATION RELATING TO CONGRESS. – Not later than 270 days after the date of enactment of this subsection, the Commission shall by rule prohibit any person from buying or selling the securities of any issuer while such person is in possession of material nonpublic information, as defined by the Commission, relating to any pending or prospective legislative action relating to such issuer if –

- (1) such information was obtained by reason of such person being a Member or employee of Congress; or
- (2) such information was obtained from a Member or employee of Congress, and such person knows that the information was so obtained.¹⁵⁸

¹⁵¹ Rep. Brian [sic] Introduces Legislation to Prohibit Insider Trading on Capitol Hill, U.S. FED. NEWS, Jan. 27, 2009 [hereinafter *Baird January 2009 Press Release*], available at 2009 WLNR 1657232. Representative Slaughter’s “STOCK Act Fact Check” press release includes a quote from a former SEC official’s statement that a congressman could trade on congressional knowledge because “he is not obligated to keep that information confidential.” Slaughter Fact Check, *supra* note 150.

¹⁵² Stop Trading on Congressional Knowledge Act, H.R. 5015, 109th Cong. (2006).

¹⁵³ See Jerke, *supra* note 12, at 1494.

¹⁵⁴ Stop Trading on Congressional Knowledge Act, H.R. 2341, 110th Cong. (2007).

¹⁵⁵ Stop Trading on Congressional Knowledge Act, H.R. 682, 111th Cong. (2009).

¹⁵⁶ See *Hearings on Unfair Trading*, *supra* note 147, at 3-8 (statements of Reps. Louise Slaughter and Brian Baird).

¹⁵⁷ Press Release, Rep. Brian Baird (D-Wash.), Baird Renews Call to Ban Insider Trading on Capitol Hill (Oct. 12, 2010) (on file with author).

¹⁵⁸ H.R. 682 § 2(a). The current version of the STOCK Act also instructs the SEC to promulgate a broader rule that would prohibit trading or tipping based on material nonpublic information obtained or derived from any federal employment. *Id.* (proposing to add a new § 10(d) to the Exchange Act). It also contains provisions requiring members of Congress

By its terms, the STOCK Act is not self-executing; rather, the Act requires the SEC to adopt its proposed ban on insider trading through rulemaking.

B. *The STOCK Act's Shortcomings*

Ironies abound in the STOCK Act. As discussed previously,¹⁵⁹ neither section 10 of the Exchange Act nor Rule 10b-5 currently makes reference to the offense of insider trading; moreover Congress has never before answered the call to amend the federal securities laws to explicitly prohibit securities trading on the basis of material nonpublic information.¹⁶⁰ Accordingly, rather than being viewed as an effective means of closing an “insider trading loophole,”¹⁶¹ the STOCK Act may well be regarded as an attempt to clarify insider trading law as it applies only to government officials, while leaving all others to struggle with the host of uncertainties inherent in the “court-drawn parameters of insider trading.”¹⁶² Shouldn't Congress first act more generally to clarify the law of insider trading for *everyone* by enacting a statute that explicitly defines and prohibits the offense of insider trading?

The claim by the co-authors of the STOCK Act that current law does not reach insider trading on congressional knowledge rings particularly hollow given the elasticity of the Rule 10b-5 insider trading prohibition. Moreover, to the extent that this elasticity has been fueled by concerns about harms to investor confidence and market integrity, an elastic interpretation of Rule 10b-5 is even more justifiable when a member of Congress uses nonpublic information obtained from his congressional service for personal profit. Indeed, even Professor Henry Manne, who has argued vehemently for the deregulation of corporate insider trading, recognizes that an unfettered ability to profit in the stock market based on nonpublic government information could

and their staffs to report specified securities transactions within ninety days of the trade, *id.* § 4(a), and requiring specified changes to the Rules of the House of Representatives, *id.* § 3. The Act also mandates rulemaking by the Commodity Futures Trading Commission (CFTC), *id.* § 2(b), although the proposed provisions regarding commodities trading may have been rendered moot by the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act, which amends the Commodity Exchange Act, 7 U.S.C. § 6c(a) (2006), to prohibit employees and agents of “any department or agency of the Federal Government” from commodities trading or tipping based on material nonpublic information obtained through their governmental service. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 746, 124 Stat. 1376, 1737-39 (2010).

¹⁵⁹ See *supra* notes 16-23 and accompanying text.

¹⁶⁰ See *supra* notes 34, 36-38, and accompanying text.

¹⁶¹ *Hearings on Unfair Trading*, *supra* note 147, at 4.

¹⁶² H.R. REP. NO. 100-910, at 11 (1988), reprinted in 1988 U.S.C.C.A.N. 6043, 6048; see Bruce Ingersoll, *Demand Rises for Law Defining Insider Trading to Provide More Than a Gut Feeling as a Guide*, WALL ST. J., Mar. 26, 1987, at 70 (quoting attorney Michael Klein's statement that insider trading law “is so laden with arcane concepts and artificial dividing lines that the layman couldn't possibly understand what's permitted and what's prohibited”); sources cited *supra* note 34.

lead to decisions “made with an eye to maximizing trading profits rather than serving the government’s interests.”¹⁶³ But even if legislative decisions are truly made with an eye to serving the public’s interest, insider trading by members of Congress nonetheless involves personal gain from the use of government information, a practice which, in and of itself, undermines the public’s trust and confidence in the government.¹⁶⁴ These potential ramifications make any double standard for congressional insider trading particularly vexing. As Professors Jonathan Macey and Erin O’Hara have argued, the SEC could be doing much more to refute the mistaken views of the current law: “What we find interesting is that the SEC is so willing to stretch the contours of the rules against insider trading when prosecuting private citizens . . . but is unwilling to make an appeal for a far more modest stretch of the rules in the context of elected public officials.”¹⁶⁵

The STOCK Act also fails to reach a host of hypothetical situations involving congressional insider trading. Under section 2(a) of the Act, the SEC is instructed to prohibit transactions in “the securities of any issuer” by persons in possession of material nonpublic information “relating to *any pending or prospective legislative action relating to such issuer,*” if the information was obtained through congressional service.¹⁶⁶ Recall Representative Slaughter’s example of Congressman B’s insider trading on the basis of nonpublic congressional information.¹⁶⁷ Because the nonpublic information related to the Appropriations Committee’s award of a defense contract to Company A, Representative Slaughter is undoubtedly correct in observing that an SEC rule giving effect to the statutory language would prohibit Congressman B from buying that company’s stock. Consider, however, these three variations:

1. Congressman B holds Company Z’s stock in his investment portfolio and Company Z is Company A’s biggest competitor. Should Congressman B be able to sell his stock in Company Z based on the

¹⁶³ HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 184 (1966). *But see id.* at 189 (“Undoubtedly it will be difficult for many people to comprehend a justification of corporate insider trading and a strong condemnation of the same practice by government officials. . . . [But, t]he distinction between private economic activity and government administration is both real and fundamental.”).

¹⁶⁴ *See* PAINTER, *supra* note 12, at 174 (arguing that “abuses of government information for private gain . . . seem incongruent with government employees’ fiduciary obligations to the public” and emphasizing that “[p]ublic confidence in government policy . . . could be compromised if inside information is likely to be abused”); *see also* *United States v. Miss. Valley Generating Co.*, 364 U.S. 520, 562 (1961) (“[A] democracy is effective only if the people have faith in those who govern, and that faith is bound to be shattered when high officials and their appointees engage in activities which arouse suspicions of malfeasance and corruption.”).

¹⁶⁵ Macey & O’Hara, *supra* note 12, at 107.

¹⁶⁶ Stop Trading on Congressional Knowledge Act, H.R. 682, 111th Cong. § 2(a) (2009).

¹⁶⁷ *See supra* note 150 and accompanying text.

nonpublic information in his possession relating to Company A? What constitutes good news for Company A may well have negative ramifications on other companies in that industry. The co-authors of the STOCK Act would likely scorn such trading but, under the terms of their bill, Congressman B's sale of Company Z would not seem to be covered because the information in Congressman B's possession did not pertain to "such issuer." The information instead pertained to its competitor, Company A.

2. What if instead of stock, Congressman B purchases options on the stock of Company A based on the nonpublic good news that the Appropriations Committee will be awarding the lucrative defense contract to Company A? Options are indeed securities under the definition in the federal securities laws,¹⁶⁸ but Company A will not generally be the issuer of those options. Once again, the statutory phrase "of such issuer" may impede successful prosecution under the STOCK Act.¹⁶⁹

3. What if instead of information pertaining to the Appropriations Committee's decision to award a multi-million dollar defense contract to Company A, Congressman B learns from an official at the Department of Defense (DOD) that it will soon be awarding a lucrative contract to Company A and Congressman B purchases stock in Company A based on that nonpublic information. Here, the nonpublic information does relate to "such issuer," but it does not relate to "any pending or prospective legislative action."¹⁷⁰ Instead, it relates to an administrative action by an executive department under the direction and supervision of a cabinet secretary who serves at the pleasure of the President.¹⁷¹

If the STOCK Act is the exclusive restraint on insider trading by members of Congress and their staffs, the gaps that would result from the enactment of

¹⁶⁸ 15 U.S.C. §§ 77b(a)(1), 78c(a)(10) (2006).

¹⁶⁹ Here, however, this gap in the STOCK Act would likely be plugged by section 20(d) of the Exchange Act, which renders insider trading in options unlawful in instances where such trading in the underlying would violate a provision in the Exchange Act. *See* 15 U.S.C. § 78t(d) ("Wherever communicating, or purchasing or selling a security while in possession of, material nonpublic information would violate, or result in liability to any purchaser or seller of the security under any provisions of this chapter, or any rule or regulation thereunder, such conduct in connection with a purchase or sale of a put, call, straddle, option, [or] privilege . . . with respect to such security . . . shall also violate and result in comparable liability to any purchaser or seller of that security under such provision, rule, or regulation.").

¹⁷⁰ *See* *United States v. Brewster*, 408 U.S. 501, 512 (1972) ("A legislative act has consistently been defined as an act generally done in Congress in relation to the business before it.").

¹⁷¹ For additional hypotheticals involving congressional insider trading that would likely fall outside of the current text of the STOCK Act, see Bainbridge, *Beltway I*, *supra* note 12, at 306.

that legislation would be enormous. The end result could well be perverse: rather than banning congressional officials “from using nonpublic information . . . to enrich their personal portfolios,”¹⁷² the specificity of the provisions in the STOCK Act could provide an effective roadmap for circumventing the very ban that its co-authors had sought. Another irony is that one of the principal impediments to a general statutory prohibition of insider trading was Congress’s fear that a statute could unintentionally “facilitate schemes to evade the law.”¹⁷³

Finally, the STOCK Act obfuscates the reality that other obstacles may prevent the SEC from pursuing suspected insider trading by members of Congress and legislative staffers, and that those other obstacles, rather than the lack of a legal duty to refrain from trading, may be the principal explanation for the paucity of investigations and the complete dearth of prosecutions. As discussed previously, insider trading cases rarely involve a smoking gun and must generally be constructed through circumstantial evidence establishing the elements of liability under Rule 10b-5.¹⁷⁴ But when trades by members of Congress or legislative staffers raise suspicions, the typical insider trading investigation may become even more complicated (and controversial). Key evidence may be located within the Capitol Building and to thwart perceived intrusions by officials from a co-equal branch of the government, members of Congress might invoke either of two constitutional protections.¹⁷⁵ First, the Speech or Debate Clause¹⁷⁶ could afford some protection from investigations involving interviews and testimony from members of Congress and their staffs, or documents and records, with respect to legislative acts.¹⁷⁷ Second, the

¹⁷² Baird January 2009 Press Release, *supra* note 151.

¹⁷³ H.R. REP. NO. 100-910, at 11 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6048.

¹⁷⁴ *See supra* notes 142-143 and accompanying text.

¹⁷⁵ *See Hearings on Unfair Trading, supra* note 147, at 35-36 (testimony of Professor Peter J. Henning, discussing possible protection for members of Congress under the Speech or Debate Clause).

¹⁷⁶ U.S. CONST. art. I, § 6, cl. 1 (“[F]or any Speech or Debate in either House, [Senators and Representatives] shall not be questioned in any other Place.”).

¹⁷⁷ *See, e.g.,* United States v. Johnson, 383 U.S. 169, 171-72, 186 (1966) (affirming reversal of former Congressman Johnson’s conviction for conspiring to defraud the U.S. government because principal evidence consisted of a speech by the Congressman which the prosecution alleged had been improperly motivated by his receipt of a bribe); *In re Grand Jury Subpoenas*, 571 F.3d 1200, 1203 (D.C. Cir. 2009) (holding that a congressman’s statements to the House Ethics Committee were protected by the Speech or Debate Clause); United States v. Rayburn House Office Bldg., 497 F.3d 654, 663 (D.C. Cir. 2007) (“The Executive’s search of the Congressman’s paper files therefore violated the [Speech or Debate] Clause, but its copying of computer hard drives and other electronic media is constitutionally permissible because the Remand Order affords the Congressman an opportunity to assert the privilege prior to disclosure of privileged materials to the Executive.”); *see also Hearings on Unfair Trading, supra* note 147, at 35-36 (testimony of Professor Peter J. Henning, observing that the proposed STOCK Act would not operate as a

Rulemaking Clause¹⁷⁸ could afford some protection against claims that would require a court to construe ambiguous provisions in congressional rules.¹⁷⁹ Yet, evidence pertaining to legislative acts or congressional rules could often be crucial in establishing that a congressional official knew, or was reckless in not knowing, that the information was both material and nonpublic at the time of his trading.

Consider again Representative Slaughter's example involving Congressman B's trading in Company A stock based on nonpublic information obtained from the Appropriations Committee. Neither the Speech or Debate Clause nor the Rulemaking Clause should insulate Congressman B from prosecution for illegal insider trading under the proposed STOCK Act,¹⁸⁰ assuming that the SEC could prove by a preponderance of the evidence that he knew he was in possession of material nonpublic information at the time of the trade and that the information was obtained by reason of his membership in Congress. But the very existence of special constitutional protections for the Legislative Branch may constitute a plainly practical explanation for why the SEC might hesitate before launching an investigation into suspicious conduct. The SEC is clearly aware of the well-publicized study of securities trading by U.S. Senators.¹⁸¹ The SEC has also, on occasion, investigated possible instances of securities trading on nonpublic congressional information,¹⁸² notwithstanding

waiver from inquiry into privileged legislative acts and emphasizing the complexity of Speech or Debate Clause issues in the context of Executive Branch requests or subpoenas for testimony and materials).

¹⁷⁸ U.S. CONST. art. I, § 5, cl. 2 ("Each House may determine the Rules of its Proceedings . . .").

¹⁷⁹ *United States v. Rostenkowski*, 59 F.3d 1291, 1305-06, 1310 (D.C. Cir. 1995) (holding that while "it is perfectly clear that the Rulemaking Clause is not an absolute bar to judicial interpretation of the House Rules," certain counts in the indictment against congressman may be non-justiciable under the doctrine of separation of powers because there is not a "judicially discoverable and manageable standard" clearly indicating whether alleged activity of a particular employee was "personal service" as opposed to "official work").

¹⁸⁰ Inquiries into insider trading, like inquiries into bribes, may not implicate the Speech or Debate Clause at all. *See United States v. Brewster*, 408 U.S. 501, 526 (1972) ("[A]n inquiry into the purpose of a bribe does not draw in question the legislative acts of the defendant member of Congress or his motives for performing them." (citation and internal quotation marks omitted)); *Rostenkowski*, 59 F.3d at 1305, 1310 (holding that neither the Rulemaking Clause nor the Speech or Debate Clause barred prosecution of a congressman with respect to counts in the indictment that required no judicial interpretation of ambiguous House rules); Bainbridge, *Beltway I*, *supra* note 12, at 302-03 (explaining why the Speech or Debate Clause "should not bar regulation of Congressional insider trading").

¹⁸¹ *See* Joseph N. DiStefano, *Senators' Stock Picks Bring Profit, Scrutiny*, PHILADELPHIA INQUIRER, Nov. 7, 2004, at E1 ("Staff at the Securities and Exchange Commission say they considered, but rejected, investigating the U.S. Senate early this year after a study found senators made suspiciously high profits from stocks during the 1990s bull market.").

¹⁸² *See* Jerke, *supra* note 12, at 1454 & n.10 (noting that SEC officials raised questions

the fact that Congress controls not only the scope of its statutory authority but also its budget. However, according to some members of its staff, the SEC may not have “press[ed] the issue” of the Senate study’s results “because it is hard to win insider-trading cases without detailed knowledge of what, if any, privileged information the subjects received and proof insiders used it to trade.”¹⁸³ The Speech or Debate Clause and the Rulemaking Clause could potentially hamper investigations involving suspected Rule 10b-5 violations when the subject is a member of Congress or a legislative staffer, and the STOCK Act does not – and cannot – do anything to change the practical effect of these constitutional protections.

III. INSIDER TRADING BY MEMBERS OF CONGRESS AND LEGISLATIVE STAFFERS

Given the expansive application of the classical and misappropriation theories that has become the norm in insider trading prosecutions under Rule 10b-5, members of Congress and legislative staffers should face an uphill battle if their principal defense in an SEC prosecution is that securities trading based on material nonpublic congressional information does not violate Rule 10b-5. Yet, as we have seen, the sponsors of the STOCK Act are convinced that “it is perfectly legal” to trade securities based on congressional information,¹⁸⁴ a view that is shared by the *Wall Street Journal*, many others in the media, and even some former SEC officials.¹⁸⁵ Distinguished securities law scholars have also voiced support for the STOCK Act, in large part because of what they perceive to be limitations under current law.¹⁸⁶

about possible tips to hedge funds of nonpublic information pertaining to an announcement by Senate Majority Leader Bill Frist concerning asbestos legislation); *cf.* PAINTER, *supra* note 12, at 174 (“Tony Rudy, a senior aide to former House Republican leader Tom Delay, bought and sold hundreds of stocks from his computer in the Capitol Building Both Rudy and Delay were eventually convicted of violating criminal laws on account of unrelated conduct”). The SEC has also investigated at least one member of Congress for suspected securities trading based on material nonpublic information that would have been obtained (if at all) from a source outside of Congress. *See* Floyd Norris, *What Did Bill Frist Know and How?*, N.Y. TIMES, Sept. 29, 2005, at C3 (reporting that Senator Bill Frist sold stock in a hospital chain that his father helped found, triggering inquiries from the SEC and the DOJ and a complaint to the Senate Ethics Committee notwithstanding the Senator’s denial that he was aware of material nonpublic information).

¹⁸³ DiStefano, *supra* note 181 (citing Ari Gabinet, then-head of the SEC’s Philadelphia office, and other SEC officials).

¹⁸⁴ *Baird March 2006 Press Release*, *supra* note 148.

¹⁸⁵ *See supra* notes 7-15 and accompanying text.

¹⁸⁶ *See, e.g.*, Bainbridge, *Beltway I*, *supra* note 12, at 307 (“Although the present Act still needs work, it is long over due.”); Macey & O’Hara, *supra* note 12, at 109 (“The most plausible explanation for the failure of this legislation is that self-interested congressional officials do not want to put an end to the lucrative trading opportunities that are made available to them when they receive important nonpublic information in their official

The notion that members of Congress and legislative staffers are not already prohibited from trading securities on the basis of nonpublic congressional knowledge is rooted in twin misconceptions: (1) a lack of regard for the broad and sweeping duties of entrustment that attach to public office and employment and (2) an unduly narrow view of the precedents establishing Rule 10b-5 liability for remaining silent about material nonpublic facts when under a fiduciary-like duty to disclose. Members of Congress are public fiduciaries who owe duties of trust and confidence to a host of parties including the citizen-investors whom they serve, as well as the federal government, fellow members of Congress, and other government officials who rely on their loyalty and integrity. Legislative staffers serve as agents and thus stand in paradigmatic fiduciary relationships with the congressional members and committees who employ them.

The contention that “Members of Congress and their staff do not owe a duty of confidentiality to Congress”¹⁸⁷ turns fiduciary law on its head. As Professor Frankel explains in her book – and as the Restatement (Second) of Agency makes clear¹⁸⁸ – a fiduciary is duty-bound to keep information confidential when it has been entrusted to him as part of his services.¹⁸⁹ A fiduciary’s use of entrusted information for personal profit also constitutes a clear violation of his duty of loyalty.¹⁹⁰ Explicit mandates with respect to confidentiality and non-use of nonpublic information merely confirm what is otherwise inherent in fiduciary relationships. But the absence of an explicit mandate does not make the obligations of loyalty and confidentiality disappear.

With these broad principles in mind, Section A focuses on insider trading by members of Congress and sets out the case for Rule 10b-5 liability, first under the classical theory and then under the complementary misappropriation theory. The analysis assumes that the SEC could successfully gather evidence

capacities.”).

¹⁸⁷ *Baird January 2009 Press Release*, *supra* note 151.

¹⁸⁸ See RESTATEMENT (SECOND) OF AGENCY § 395 (1958) (“[A]n agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury at the principal.”).

¹⁸⁹ See FRANKEL, *supra* note 31, at 7 (“Entrustment is the most important aspect of fiduciary relationships. It greatly affects the existence, nature, and the rules of fiduciary relationships. The word ‘confidence’ that courts occasionally use may mean more than mere confiding in the other party. It can mean confiding secrets as well.”).

¹⁹⁰ See *id.* at 108 (“The duty of loyalty supports the main purpose of fiduciary law: to prohibit fiduciaries from misappropriating or misusing entrusted property or power.”); see also RESTATEMENT (SECOND) OF AGENCY § 395. Professor Frankel goes on to explain that the duty of loyalty is manifested by “important preventive rules” that prohibit actions “even though they are not necessarily injurious to entrustors.” FRANKEL, *supra* note 31, at 108. These preventive rules “act to dampen the fiduciaries’ temptations to misappropriate entrusted property or power, or to justify benefitting themselves, and establish a continuous reminder that entrusted property and power do not belong to the fiduciaries.” *Id.*

and prove that securities were traded on the basis of material nonpublic congressional information. Using hypothetical facts such as those identified in Representative Slaughter's example, the conclusion that Congressman B breached a duty of trust and confidence and thereby violated Rule 10b-5 can be established as a matter of law. Section B argues that despite the strength of the legal arguments for Rule 10b-5 liability, education, rather than prosecution, may be the SEC's most effective enforcement tool. Section C focuses on legislative staffers and other congressional employees, and Section D briefly examines issues relating to "tips" which convey material nonpublic congressional information.

A. *Members of Congress*

1. The Case for Liability under the Classical Theory

As we have seen, Rule 10b-5 liability under the classical theory "is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction."¹⁹¹ Thus, for Congressman B's silence about the multi-million defense contract to be deemed a fraud under the classical theory, he would have to owe a disclosure duty to Company A stockholders who sold their shares without the benefit of the Appropriations Committee's information which would have made their stock more valuable. This duty of disclosure can arise from either of two relationships: (a) from the relationship of trust and confidence that exists between members of Congress and the securities issuers that have business before them (rendering congressional officials temporary or constructive insiders of the issuer) or (b) from the relationship of trust and confidence that exists between members of Congress and citizen-investors (some of whom are shareholders in Company A).

a. *Temporary or Constructive Insiders*

Under circumstances such as those postulated by Representative Slaughter, Congressman B could be viewed as a temporary or constructive insider of Company A since he was entrusted with access to nonpublic information pertaining to the Company's imminent receipt of a lucrative defense contract. Indeed, Congress itself has gone so far as to recognize that government officials can, under certain circumstances, assume the status of constructive insiders. In justifying the view that a legislative definition of insider trading is unnecessary, the Committee Report accompanying the Insider Trading Sanctions Act of 1984 (ITSA) observed (with remarkable prescience) that:

Underwriters, investment analysts, lawyers, accountants, financial printers, *government officials*, and others often learn of profit-or-loss forecasts, imminent tender offers, mineral strikes, oil discoveries, *lucrative contracts*, and product failures before such information is

¹⁹¹ Chiarella v. United States, 445 U.S. 222, 230 (1980).

available to the investing public. Insider trading by such persons undermines confidence in the markets in the same manner as trading by corporate insiders. The Supreme Court recently noted [in *Dirks*] that under certain conditions, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer or consultant working for the corporation, those “outsiders” may be treated as constructive insiders. *The Committee agrees with this analysis and expects the Commission to continue to pursue violations by such persons.*¹⁹²

Professor Louis Loss likewise included government officials in a suggested category of “quasi-insiders” who would be prohibited from insider trading under section 1603 of the American Law Institute’s proposed Federal Securities Code which was presented to Congress, but never adopted.¹⁹³

Viewing members of Congress as temporary or constructive insiders, at least when they have been entrusted with nonpublic company-specific information like the imminent receipt of a defense contract (or, for example, proprietary corporate information provided pursuant to a congressional committee’s investigative subpoena), fits well within the classical framework of *Chiarella* and *Dirks*. Like an issuer’s traditional insiders and temporary agents, as well as their tippees, congressional officials should not be permitted to take advantage of “information intended to be available only for a corporate purpose and not for the personal benefit of anyone.”¹⁹⁴ It would thus be quite reasonable to impute a disclosure obligation when a member of Congress trades with shareholders of the issuer who were not privy to facts affecting the value of their shares. The failure to disclose to shareholders in such a circumstance would constitute a violation of Rule 10b-5.

b. *Public Fiduciaries and Citizen-Investors*

Viewing Congressman B as a public fiduciary who owes disclosure duties to at least some of the shareholders of Company A provides an alternative avenue under the classical theory for rendering his stock purchases a fraud. Moreover, arguments predicated on members of Congress as public fiduciaries would apply in a host of other instances where the temporary or constrictive insider theory may not. For instance, if the information in Congressman B’s possession concerned an anticipated change in the tax laws that had yet to be

¹⁹² H.R. REP. NO. 98-355, at 4 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2277 (emphasis added).

¹⁹³ FED. SEC. CODE § 1603 cmt. (3)(d) (1980) (“It would be convenient to have a new category of ‘quasi insider’ that would cover people like (i) judges’ clerks who trade on information in unpublished opinions, [and] (ii) Federal Reserve Bank employees who trade with knowledge of an imminent change in the margin rate” (citing the *Peltz*, *Blyth*, and *Keane* decisions discussed at *infra* notes 101, 269-276)). Chief Justice Burger specifically referenced this ALI proposal in his dissenting opinion in *Chiarella*, 445 U.S. 222, 242 n.3 (1980) (Burger, C.J., dissenting).

¹⁹⁴ *Dirks v. SEC*, 463 U.S. 646, 654 (1983) (internal quotation marks omitted).

announced publicly, viewing Congressman B as a constructive insider of each and every company affected by that law may well be too much of a stretch. Yet, if Congressman B bought stock in Companies X, Y, and Z based on material nonpublic information about such a change in the tax law, the SEC would have a compelling argument that Congressman B owes at least some of the shareholders with whom he trades a disclosure obligation in accordance with his status as a public fiduciary.

As Professor Frankel observes in the epilogue to her book, “[p]rivate sector fiduciaries and government officials have much in common” because the law governing both sets of actors “address similar problems, and the guiding principles in both legal systems are similar: prevent misappropriation of entrustment and ensure a diligent and expert performance of services.”¹⁹⁵ Here Professor Frankel quotes Professor Robert Natelson’s forceful argument that the “Constitution was conceived of as a fiduciary instrument, instituting, to the extent practicable, fiduciary standards.”¹⁹⁶ Professor Frankel also reminds us that the U.S. Constitution refers in several places to “public Trust”¹⁹⁷ and to public offices being “of Trust.”¹⁹⁸ She emphasizes that the “freedom and well-being of this country’s people depend on the accountability of both [private and government] fiduciaries and on preventing them from misappropriating their entrusted property and power.”¹⁹⁹ Professor Richard Painter builds on Professor Frankel’s work when he recognizes that “[p]ersons who choose elected officials are entrustors to whom officials owe fiduciary obligations.”²⁰⁰ He notes specifically that “[f]or members of Congress, the entrustors are the voters in their districts,” though he recognizes that “fiduciary obligations may also be owed to other persons.”²⁰¹

¹⁹⁵ FRANKEL, *supra* note 31, at 279. To be sure, some scholars take issue with Professor Frankel’s highly expansive conception of fiduciary duties and relationships. *See, e.g.*, Larry Ribstein, *Fencing Fiduciary Duties*, 91 B.U. L. REV. 899, 901-03 (2011) (arguing for a narrower definition of fiduciary duty and a more precise application that would turn on the concept of unselfishness); Smith, *supra* note 121, at 1402 (setting forth a definition of a fiduciary relationship that would turn on three core requirements: “when one party (the ‘fiduciary’) acts on *behalf of* another party (the ‘beneficiary’) while exercising *discretion* with respect to a *critical resource* belonging to the beneficiary” (emphasis added)). Members of Congress, as representatives elected to serve the public interest, may well fit within some of these other, more restrictive, conceptions of the term “fiduciary.”

¹⁹⁶ FRANKEL, *supra* note 31, at 280 (quoting Robert G. Natelson, *Judicial Review of Special Interest Spending: The General Welfare Clause and the Fiduciary Law of the Founders*, 11 TEX. REV. L. & POL. 239, 281 (2007)).

¹⁹⁷ U.S. CONST. art. VI, cl. 3.

¹⁹⁸ U.S. CONST. art. I, § 3, cl. 7; *id.* art. I, § 9, cl. 8; *id.* art. II, § 1, cl. 2.

¹⁹⁹ FRANKEL, *supra* note 31, at 286.

²⁰⁰ PAINTER, *supra* note 12, at 2.

²⁰¹ *Id.* For law review articles recognizing that government officials are fiduciaries who operate under strict limitations with respect to their use of government power and property, see Kathleen Clark, *Do We Have Enough Ethics In Government Yet?: An Answer from*

In arguing against the classical theory's application to his purchases of stock in Company A, Congressman B might contend that his silence about material facts does not defraud the issuer's selling shareholders because his duties of entrustment vis-à-vis the public are not characteristic of the type of fiduciary-like relationship that has triggered the requisite duty to disclose under prior Rule 10b-5 insider trading precedents. To bolster this argument, he would likely point out that "[f]iduciary law does not provide citizens with broad equitable remedies against government officials for breach of trust,"²⁰² and that while his constituents can vote him out of office for conduct inconsistent with trust and loyalty, citizen-investors "cannot sue for breach of fiduciary duty."²⁰³ Moreover, as a member of the House of Representatives, his responsibilities as a public official are unique because "Congress is not a job like any other, it is a constitutional role to be played upon a constitutional stage."²⁰⁴ These observations are all quite valid, as far as they go.

But members of Congress can be held accountable for their fiduciary breaches in at least two additional ways. First, a member of Congress can be punished by his own House for acts that constitute a betrayal of the public's trust. Second, at least some breaches of the public's trust by a member of Congress can be prosecuted by the Executive Branch under criminal and civil statutes. These vehicles for accountability evidence that congressional duties of entrustment are both bona fide and enforceable, even if citizens typically do not have standing to vindicate those rights in court.

Congress's authority to punish its own members for breaches of entrustment is grounded in the Constitution's text, which states that: "Each House may determine the Rules of its Proceedings, punish its Members for disorderly Behavior, and with the Concurrence of two-thirds, expel a Member."²⁰⁵ This

Fiduciary Theory, 1996 U. ILL. L. REV. 57 (1996); Joseph J. Kalo, *Detering Misuse of Confidential Government Information: A Proposed Citizens' Action*, 72 MICH. L. REV. 1577 (1974); David M. Lawrence, *Local Government Officials as Fiduciaries: The Appropriate Standard*, 71 U. DET. MERCY L. REV. 1 (1993); Note, *The Fiduciary Duty of Former Government Employees*, 90 YALE L.J. 189 (1980).

²⁰² PAINTER, *supra* note 12, at 3.

²⁰³ *Id.*

²⁰⁴ *United States v. Rostenkowski*, 59 F.3d 1291, 1312 (D.C. Cir. 1995).

²⁰⁵ U.S. CONST. art. I, § 5, cl. 2. For an extensive examination of this Clause (including the Framers' intent and its application from the nation's founding through modern times), see Laura Krugman Ray, *Discipline Through Delegation: Solving the Problem of Congressional Housecleaning*, 55 U. PITT. L. REV. 389 (1994). Professor Ray argues that while the text of the Constitution may be read to provide for an alternative avenue of punishment under the Impeachment Clause, U.S. CONST. art. II, § 4, "history has effectively closed that option." Ray, *supra*, at 391; *see also id.* at 397-401 (discussing the Senate's conclusion that it lacked jurisdiction over the 1797 impeachment of then-expelled Senator William Blount and speculating that the Senate (which reached its decision in closed session) may have accepted Blount's argument that the Senate's power of expulsion renders impeachment unnecessary and/or that the Constitution does not expressly include members

self-discipline for “disorderly Behavior” is to be administered by the member’s own House, and as the Supreme Court recognized in *In re Chapman*,²⁰⁶ even the “right to expel” – the ultimate and the rarest form of congressional self-discipline – “extends to all cases where the offense is such as in the judgment of the Senate [or the House of Representatives] is inconsistent with the trust and duty of a member.”²⁰⁷

Although Congress is frequently criticized for its reluctance to administer any self-discipline (even through the relatively mild sanctions of denouncement or reprimand), there is no doubt that each House has the authority to proscribe and sanction betrayals of the public trust.²⁰⁸ Indeed, both the Senate Ethics Manual²⁰⁹ and the House Ethics Manual²¹⁰ reference not only their own expansive ethical standards and jurisdiction²¹¹ but also a general Code of Ethics for Government Service,²¹² which sets out ten broadly-worded ethical standards that should be adhered to “by all Government employees, including officeholders . . . ever conscious that public office is a public trust.”²¹³ Reflecting the fiduciary obligation of loyalty, the Code’s eighth provision specifies that an official should “never use any information coming to him confidentially in the performance of government duties as a means for

of Congress in the Impeachment Clause).

²⁰⁶ 166 U.S. 661 (1897).

²⁰⁷ *Id.* at 669-70.

²⁰⁸ See Theresa A. Gabaldon, *The Self-Regulation of Congressional Ethics: Substance and Structure*, 48 ADMIN. L. REV. 39, 45-46 (1996) (observing that at least one Senator has been censured for actions “derogate[ing] from the public trust expected of a senator” even though the conduct at issue had not violated “any specific law or rule in force at the time,” but acknowledging that “neither the House nor the Senate has taken formal disciplinary action on a frequent basis” (alteration in original, internal quotation marks omitted)); Ray, *supra* note 205, at 390 (discussing the disciplinary role assigned to Congress under the Constitution, but contending that Congress’s “performance to date scarcely vindicates its claim to effective self-discipline”). See generally PAINTER, *supra* note 12, at 143-63 (discussing recent Legislative Branch ethics reform).

²⁰⁹ STAFF OF S. SELECT COMM. ON ETHICS, 108TH CONG., SENATE ETHICS MANUAL (Comm. Print 2003), available at <http://ethics.senate.gov/downloads/pdf/files/manual.pdf>.

²¹⁰ STAFF OF H. COMM. ON STANDARDS OF OFFICIAL CONDUCT, 110TH CONG., HOUSE ETHICS MANUAL (Comm. Print 2008), available at http://ethics.house.gov/Media/PDF/2008_House_Ethics_Manual.pdf.

²¹¹ *Id.* at 1-4 (setting out “General Ethical Standards”); SENATE ETHICS MANUAL 309-11 (setting out “The Senate Code of Official Conduct”).

²¹² HOUSE ETHICS MANUAL 355 (including the Code in the appendix); SENATE ETHICS MANUAL 7 (referencing the Code). The Code has been explicitly incorporated into House ethics rules. HOUSE ETHICS MANUAL 20. And while the Senate’s ethics rules do not incorporate the Code specifically, the Senate Ethics Manual does identify the Code as a “source of Committee jurisdiction.” SENATE ETHICS MANUAL 7.

²¹³ Code of Ethics for Government Service, H.R. Con. Res. 175, 85th Cong., 72 Stat. B12 (1958).

making personal profit,”²¹⁴ and there has been at least one disciplinary reprimand of a congressman found to have unjustly enriched himself in violation of this provision.²¹⁵

A member of Congress can likewise be held accountable for breaches of entrustment through prosecutions by the Executive Branch under federal criminal and civil statutes, including statutes tailored to conduct by members of Congress (as a specific class or as part of a broader class of “public officials”)²¹⁶ and statutes of general application.²¹⁷ The federal statutes prohibiting mail fraud²¹⁸ and wire fraud²¹⁹ constitute cogent examples of generally-applicable criminal statutes which can encompass a member of Congress’s breach of the “fiduciary duty of loyalty” that he owes to the American public.²²⁰

²¹⁴ *Id.*

²¹⁵ HOUSE ETHICS MANUAL 249 (citing HOUSE COMM. ON STANDARDS OF OFFICIAL CONDUCT, IN THE MATTER OF A COMPLAINT AGAINST REPRESENTATIVE ROBERT L.F. SIKES, H. REP. 94-1364, at 3 (1976)). The House Ethics Manual recounts that the Congressman had purchased 2,500 shares of a privately-held bank’s stock while he was actively assisting in the establishment of that bank on a military base, and observes that had the Congressman requested an opinion of the “House Standards Committee in advance about the propriety of the investment, it would have been disapproved.” *Id.*

²¹⁶ Congress has enacted a host of anti-corruption statutes that expressly apply to government officials, including members of Congress. *See, e.g.*, United States v. Brewster, 408 U.S. 501, 502 n.2, 528-29 (1972) (holding that the Speech and Debate Clause does not bar prosecution of congressman for violation of an anti-bribery statute applying to “any public official” including any “member of Congress” even if a congressman accepted the bribe in exchange for a promise relating to an official act); *see also* WILLIAM N. ESKRIDGE, JR. ET AL., CASES AND MATERIALS ON LEGISLATION: STATUTES AND THE CREATION OF PUBLIC POLICY 301-18 (4th ed.) (discussing anti-bribery statutes and “conflict of interest” statutes applying to “public officials,” including the Ethics Reform Act of 1989, 5 U.S.C. § 7353(a) (2006), which prohibits members of Congress from seeking or accepting “anything of value” from any person “whose interests may be substantially affected by the performance or nonperformance of the individual’s official duties”).

²¹⁷ *See* ESKRIDGE, JR. ET AL., *supra* note 216, at 310 n.d (citing the federal mail and wire fraud statutes, 18 U.S.C. §§ 1341, 1343 (2006), the Hobbs Act, 18 U.S.C. § 1951 (2006) (criminalizing extortion), and the Travel Act, 18 U.S.C. § 1952 (2006), as examples of federal criminal statutes that might be used to prosecute “official legislative conduct at either the federal or state level”).

²¹⁸ 18 U.S.C. § 1341 (prohibiting “schemes or artifices to defraud” through the use of the mails).

²¹⁹ 18 U.S.C. § 1343 (prohibiting “schemes or artifices to defraud” through use of electronic wires, radio, or television).

²²⁰ *Restoring Key Tools to Combat Fraud and Corruption After the Supreme Court’s Skilling Decision: Hearing Before S. Comm. on the Judiciary*, 111th Cong. (2010) [hereinafter *Skilling Decision Hearing*] (statement of Lanny A. Breuer, Assistant Att’y Gen., Criminal Division, Department of Justice), <http://judiciary.senate.gov/pdf/9-28-10%20Breuer%20Testimony.pdf> (stating that for decades, federal prosecutors have used the

Several members of Congress have been indicted, and have served (or are serving) time in prison, for honest services fraud prosecuted under either 18 U.S.C. § 1346²²¹ or the so-called pre-*McNally* interpretations of the federal mail and wire fraud statutes.²²² Congress enacted § 1346 in response to the Supreme Court's decision in *McNally v. United States*²²³ which, in the context of a prosecution involving the corruption of a state public official, narrowly interpreted the mail fraud statute to apply only to fraudulent deprivations of "property rights" and not to schemes "defraud[ing] citizens of their intangible rights to honest and impartial government."²²⁴ Section 1346 reflects

mail and wire fraud statutes to reach "schemes designed to *deprive citizens* of the honest services of public and private officials who owe them a *fiduciary duty of loyalty*" and observing that some of these prosecutions and convictions have involved members of Congress (emphasis added).

²²¹ 18 U.S.C. § 1346 ("For the purposes of this chapter [(the federal mail and wire fraud statutes)], the term 'scheme or artifice to defraud' includes a scheme or artifice to deprive another of the intangible right of honest services.").

²²² See *Skilling Decision Hearing*, *supra* note 220 (statement of Lanny A. Breuer, testifying that, in connection with schemes involving bribery, "[f]ormer Congressman William Jefferson was convicted in 2009 of honest services fraud" and "[f]ormer Congressman Robert Ney pleaded guilty in 2006 to honest services fraud conspiracy"). Other members of Congress who were indicted under § 1346 for honest-services fraud include: former Illinois Congressman Dan Rostenkowski, *see infra* notes 249-252; former California Congressman Randy Cunningham, *see* Information at 3-4; *United States v. Cunningham*, Criminal Case No. 05cr2137-LAB (S.D. Cal. Nov. 28, 2005) (charging use of the mails to conspire "to devise a material scheme to defraud the United States of its right to defendant's honest services, including its right to his conscientious, loyal, faithful, disinterested, unbiased service, to be performed free of deceit, undue influence, conflict of interest, self-enrichment, self-dealing, concealment, bribery, fraud and corruption"); and former Arizona Congressman Richard Renzi, *see* Indictment at 10-11, *United States v. Renzi*, CR08-0212TUC (D. Ariz. filed Feb. 20, 2008) (charging use of the wires to "devise a scheme and artifice to defraud and deprive the United States of its intangible right to the honest services of Renzi performed free from deceit, self-dealing, bias and concealment" for purposes including the concealment of Renzi's financial relationship with co-conspirators from private persons, "the United States House of Representatives, and the public"). For a pre-*McNally* indictment charging former Congressman Charles Diggs with honest-services fraud in connection with a kick-back scheme, *see infra* notes 232-233 and accompanying text.

²²³ 483 U.S. 350 (1987).

²²⁴ *Id.* at 355. The majority in *McNally* noted that, like the federal mail fraud statute under which the defendant had been prosecuted, the federal anti-conspiracy statute, 18 U.S.C. § 371, also uses the words "to defraud." *Id.* at 358 n.8 (quoting statutory language making criminal any conspiracy "to defraud the United States, or any agency thereof in any manner or for any purpose." (internal quotation marks omitted)). The majority further observed that prior Court precedents had interpreted § 371 (or its statutory predecessor) to reach acts that not only defraud "the Government out of property or money," but also acts that "interfere with or obstruct one of its lawful government functions." *Id.* (internal quotation marks omitted). However, the Court acknowledged that the words "to defraud"

Congress's intent to restore the pre-*McNally* honest-services fraud doctrine,²²⁵ but just last term in *Skilling v. United States*,²²⁶ the Court gave § 1346 a narrow construction, holding that constitutional due process requires the statute's proscription of fraudulent deprivations of "the intangible right of honest services" to criminalize only conduct involving bribes or kickbacks.²²⁷

The fact that members of Congress may be criminally liable for bribe-and-kickback schemes that "defraud and deprive American citizens of their right to [receive] honest services" presupposes that congressional loyalty and honesty are positive public rights and enforceable legal interests.²²⁸ This presupposition squares with the *McNally* Court's description of the prior case law as holding that "a public official owes a fiduciary duty to the public, and a misuse of his office for private gain is a fraud."²²⁹ In his *Skilling* dissent, Justice Scalia observed disparagingly that "[n]one of the 'honest services' cases, neither those pertaining to public officials nor those pertaining to the private employees, defined the nature and the content of the fiduciary duty central to the 'fraud' offense."²³⁰ Yet, for the *Skilling* majority, such imprecision was of no moment because in its view, in the bribe-and-kickback cases held to be within § 1346's constitutional scope, "[t]he existence of a fiduciary relationship, under any definition of that term, was usually beyond dispute."²³¹ Among many of the honor-services fraud precedents "blessed" by

could have different meanings in each statute given the statutes' differing origins and aims. *Id.* ("Section 371 is a statute aimed at protecting the Federal Government alone; however, the mail fraud statute . . . had its origin in the desire to protect individual property rights . . ."). The Court then concluded that "any benefit which the Government derives from the [mail fraud] statute must be limited to the Government's interest as property holder." *Id.*

²²⁵ See Craig M. Bradley, *Not All Dishonesty is 'Honest Services' Fraud*, 46 TRIAL 48, 49 (2010). In *McNally*, the Court instructed that "if Congress desires to go further, it must speak more clearly." *McNally*, 483 U.S. at 360. As Professor Bradley observes, in response to *McNally*, "Congress did speak – if not very clearly – when it . . . enact[ed] the honest-services fraud statute, 18 U.S.C. § 1346, in 1988." Bradley, *supra*, at 49.

²²⁶ 130 S. Ct. 2896 (2010).

²²⁷ *Id.* at 2931 ("[Section] 1346 criminalizes *only* the bribe-and-kickback core of the pre-*McNally* case law."). The Court reached this holding because "there is no doubt that Congress intended § 1346 to reach *at least* bribes and kickbacks," whereas "[r]eading the statute to proscribe a wider range of offensive conduct . . . would raise the due process concerns underlying the vagueness doctrine." *Id.*

²²⁸ *United States v. Jefferson*, 562 F. Supp. 2d 719, 721, 725 (E.D. Va. 2008) (denying motion to dismiss counts of indictment charging then-Congressman William Jefferson with "a scheme to defraud and deprive American citizens of their right to [his] honest services by taking bribes . . . in return for [his] performance of various official acts" and concluding that these honest-services fraud counts were not unconstitutionally vague); see sources cited *supra* note 222.

²²⁹ *McNally*, 483 U.S. at 355.

²³⁰ *Skilling*, 130 S. Ct. at 2936 (Scalia, J., dissenting).

²³¹ *Id.* at 2930 n.41 (majority opinion). The Court then provided three specific examples of undisputed fiduciary relationships (public official-public, employee-employer, and union

the *Skilling* Court was *United States v. Diggs*,²³² a 1979 D.C. Circuit decision that affirmed former Michigan Congressman Charles Digg's conviction for mail fraud in connection with a staff salary kick-back scheme that "defrauded the public of not only substantial sums of money but of his faithful and honest services."²³³

The public fiduciary principles observed by Professor Frankel with respect to the appropriate use of government property and power, when combined with the specific application of those principles in the context of congressional self-discipline and § 1346 honest-services fraud prosecutions against members of Congress, form a powerful case that Congressman B would violate Rule 10b-5 under the classical theory were he to use material nonpublic information concerning an unannounced defense contract (or an anticipated change in the tax laws) to personally profit from trading in the securities of an affected company. To be sure, the Court in *Chiarella* and *Dirks* insisted that there is no "general duty between all participants in market transactions to forgo actions based on material, nonpublic information."²³⁴ But as a person who has been entrusted with public power and authority for a public purpose, Congressman B stands in a "special relationship" with the members of the public with whom he trades,²³⁵ and Congressman B would be using information intended only for government purposes for his own personal gain.²³⁶ Accordingly, as a person who owes bona fide and enforceable duties of trust and confidence to the general public (including at least some of Company A's shareholders), Congressman B would violate Rule 10b-5 were he to purchase stock while remaining silent about material nonpublic facts pertaining to an anticipated change in the tax law or the imminent award of a defense contract by either the Appropriations Committee or the DOD.²³⁷

official-union members) and followed those with a "see generally" to *Chiarella v. United States*, 445 U.S. 222, 233 (1980), with a parenthetical explaining that *Chiarella* discussed the "established doctrine that [a fiduciary] duty arises from a specific relationship between two parties." *Id.* (internal quotation marks omitted).

²³² *United States v. Diggs*, 613 F.2d 988 (D.C. Cir. 1979). *Diggs* was cited in *Skilling*, 130 S. Ct. at 2929 n.38.

²³³ *Diggs*, 613 F.2d. at 998; *see infra* notes 242-248.

²³⁴ *Dirks v. SEC*, 463 U.S. 646, 655 (1983) (quoting *Chiarella*, 445 U.S. at 233) (internal quotation marks omitted).

²³⁵ *Cf. Chiarella*, 445 U.S. at 246 (Blackmun, J., dissenting) (observing that the majority had predicated insider trading liability on a "special relationship akin to fiduciary duty" (internal quotation marks omitted)); *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1972); *supra* text accompanying notes 59-61.

²³⁶ *Cf. Dirks*, 463 U.S. at 654 ("[The] fraud derives from the inherent unfairness involved where one takes advantage of information intended to be available only for a corporate purpose and not for the personal benefit of anyone." (internal quotation marks omitted)).

²³⁷ Although they speculate that a narrower view could prevail, Professors Macey and O'Hara have expressed support for the classical theory's application to members of Congress who serve as public fiduciaries. *See Macey & O'Hara, supra* note 12, at 107

2. The Case for Liability under the Misappropriation Theory

Because Congressman B's use of the Appropriations Committee's nonpublic information about the award of a defense contract would constitute a self-serving use of government property, the complementary misappropriation theory would provide an alternative ground for liability under Rule 10b-5. As a public servant and an official of the federal government, Congressman B's undisclosed misuse of nonpublic information would deceive a host of persons including: a) the United States and its citizens as "entrustors," b) the federal government in its capacity as his employer, and c) his fellow members of Congress or other government officials. Moreover, even in the absence of a court's willingness to regard Congressman B as a fiduciary owing disclosure duties to these persons, a fourth basis of liability under the misappropriation theory could attach from Congressman B's undisclosed breach of an obligation under the Code of Ethics for Government Service to never use confidential information as a means for making personal profit.

a. *The United States and its Citizens as "Entrustors" of Property*

The argument under the misappropriation theory for Congressman B's deception of the federal government and its citizens reflects many of the same fiduciary principles discussed above under the classical theory.²³⁸ Under the misappropriation theory, Congressman B would be defrauding the government and its citizens by using their information for personal gain in securities trading while maintaining a pretense of loyalty.²³⁹ Thus, Congressman B

("[E]lected officials who serve on committees and, in their official capacities . . . would clearly seem to owe a 'generalized' fiduciary duty to the public, including the securities markets."). Professor Donald Langevoort advanced a similar argument years before. Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CALIF. L. REV. 1, 34-35 (1982) (maintaining that the investors trading with a government official "could be viewed as members of the broader class – the country's citizens – to whom the official does owe some duty of fair dealing"). Professor Langevoort points out that "[l]ike the corporate insider, the government official has an advantageous position as compared to the persons whom he is charged with serving" and thus both insider and government officials could be governed by the same principle "of preventing unjust enrichment." *Id.*; see also John F. Barry III, *The Economics of Outside Information and Rule 10b-5*, 129 U. PA. L. REV. 1307, 1374-76 (1981) (discussing insider trading by government officials and concluding that "a public official using official information for private gain violates a panoply of legal restrictions that trigger a disclose or abstain obligation under the common law and rule 10b-5"). For additional commentary written pre-Chiarella, see Arthur Fleischer, Jr. et al., *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 823-24 (1973) ("[I]t is reasonable to expect that such information will not be used for the personal advantage of [government officials] who are given preferred access to it.").

²³⁸ Cf. LANGEVOORT, *supra* note 74, at § 6-2 ("Virtually all cases that could be brought [under the classical theory] can also be styled as misappropriation cases.").

²³⁹ See *United States v. O'Hagan*, 521 U.S. 642, 653-54 (1997) ("A fiduciary who

“deal[s] in deception”²⁴⁰ and his purchases of stock in Company A would violate Rule 10b-5. The first subsection below discusses prior prosecutions of members of Congress for defrauding the United States and its citizens through the misappropriation of funds and other tangible property; the second subsection discusses a government’s property interest in its material nonpublic information.

i. Prosecutions for Fraudulent Misappropriation of Funds and Tangible Property

Although there has yet to be a federal prosecution for the undisclosed, self-serving use of congressional knowledge for personal profit, over the last half-century, several members of Congress have been indicted for defrauding the federal government and its citizen through the misappropriation of funds and other tangible property.²⁴¹ In *United States v. Diggs*,²⁴² for example, the D.C. Circuit considered an appeal by former Michigan Congressman Charles Diggs. In affirming his conviction for mail fraud under 18 U.S.C. § 1341, the court recounted the jury’s findings that the Congressman had greatly increased the salaries nominally paid to his staff out of the clerk hire allowance, and that he had used the increases himself for personal expenses.²⁴³ The D.C. Circuit concluded that the Congressman’s conduct “amounted to no less than a scheme to take illicit kick-backs” and that this scheme “defrauded the public of not only substantial sums of money but of his faithful and honest services.”²⁴⁴ Although the constitutionality of the honest-services fraud part of this holding may have been subject to question prior to *Skilling*,²⁴⁵ fraudulent deprivations of money and other tangible property have always been at the core of the federal mail and wire fraud statutes.²⁴⁶ Diggs was sentenced to three years in

[pretends] loyalty to the principal while secretly converting the principal’s information for personal gain dupes or defrauds the principal.” (alteration in original, citation and internal quotation marks omitted)); *supra* text accompanying note 78.

²⁴⁰ *O’Hagan*, 521 U.S. at 653-54.

²⁴¹ See generally Clark, *supra* note 201, at 59-60 (discussing a host of ethics investigations targeting members of Congress); Craig S. Lerner, *Legislators as the “American Criminal Class”: Why Congress (Sometimes) Protects the Rights of Defendants*, 2004 U. ILL. L. REV. 599, 663-72 (2004) (setting out detailed appendix listing nearly 100 members of Congress who have been indicted for a wide range of criminal offenses, some of which involved the misappropriation of federal property).

²⁴² *United States v. Diggs*, 613 F.2d 988 (D.C. Cir. 1979).

²⁴³ *Id.* at 994-95.

²⁴⁴ *Id.* at 998.

²⁴⁵ See *supra* notes 226-227.

²⁴⁶ *McNally v. United States*, 483 U.S. 350, 360 (1987) (holding that the mail fraud statute was “limited in its scope to the protection of property rights” and observing that property included money or other tangible property); *supra* notes 223-225.

prison,²⁴⁷ and agreed to accept a censure by the House “in return for an end to the committee investigation of his financial dealings.”²⁴⁸

Former Illinois Congressman Daniel Rostenkowski provides a second example of a member of Congress who was charged under general statutes with offenses involving, among other things, the fraudulent misappropriation of government funds and property. In *United States v. Rostenkowski*,²⁴⁹ the D.C. Circuit rejected the argument that the Speech or Debate Clause and the Rulemaking Clause stood as an absolute bar to a seventeen count indictment “alleging generally that Rostenkowski and others had devised . . . a scheme to defraud the United States of its money, its property, and its right to Rostenkowski’s fair and honest services” in connection with staff salary kickbacks, misappropriation of goods worth over \$40,000 (including crystal sculptures, wooden armchairs, and fine china from the House Stationary Store), and misappropriation of funds by exchanging stamp vouchers for cash.²⁵⁰ Rostenkowski was subsequently defeated in his bid for re-election,²⁵¹ served fifteen months in prison after pleading guilty in 1996 to two felony mail fraud counts, and was pardoned in 2000 by President Clinton.²⁵²

Lest it appear that misappropriation of congressional funds and property plagues only the House of Representatives, former Minnesota Senator David Durenberger’s prosecution and subsequent guilty plea indicates otherwise. Durenberger had been charged with making and presenting false claims for Senate reimbursement of his travel expenses,²⁵³ in violation of the anti-conspiracy statute²⁵⁴ and the False Claims Act.²⁵⁵ In affirming the district court’s denial of the Senator’s motion to dismiss the indictment, the D.C.

²⁴⁷ Lerner, *supra* note 241, at 666.

²⁴⁸ Ray, *supra* note 205, at 414.

²⁴⁹ 59 F.3d 1291 (D.C. Cir. 1995).

²⁵⁰ *Id.* at 1294 (alteration in original, internal quotation marks omitted). The seventeen counts included charges that Rostenkowski had violated the federal mail and wire fraud statutes, 18 U.S.C. §§ 1341, 1343, 1346 (2006), the anti-conspiracy statute, 18 U.S.C. § 371 (2006), and the prohibition against conversion of U.S. funds and property, 18 U.S.C. § 641 (2006).

²⁵¹ Clark, *supra* note 201, at 60 n.9.

²⁵² Neil A. Lewis, *Clinton Issues a Pardon To Ex-Rep. Rostenkowski*, N.Y. TIMES, Dec. 23, 2000, at A12.

²⁵³ *United States v. Durenberger*, 48 F.3d 1239, 1240 (D.C. Cir. 1995).

²⁵⁴ 18 U.S.C. § 371 (“If two or more persons conspire . . . to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined under this title or imprisoned not more than five years, or both.”).

²⁵⁵ 18 U.S.C. § 287 (2006) (“Whoever makes or presents to any person or officer in the civil, military, or naval service of the United States, or to any department or agency thereof, any claim upon or against the United States, or any department or agency thereof, knowing such claim to be false, fictitious, or fraudulent, shall be imprisoned not more than five years and shall be subject to a fine in the amount provided in this title.”).

Circuit observed that Durenberger had allegedly concealed his ownership interest in a condominium while claiming entitlement for \$3825 in reimbursement for overnight stays.²⁵⁶ Durenberger was then denounced by the Senate, did not seek re-election, and later pleaded guilty to misdemeanor charges.²⁵⁷

ii. Material Nonpublic Information as Intangible Property

As we have seen, in *O'Hagan*,²⁵⁸ the Supreme Court endorsed the misappropriation theory of insider trading liability under Rule 10b-5 because a “fiduciary’s undisclosed, self-serving use of a principal’s information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information.”²⁵⁹ The *O'Hagan* Court further recognized that the material nonpublic information on which the defendant-attorney had traded qualified as “property.”²⁶⁰ In so ruling, the Court relied on *Carpenter v. United States*,²⁶¹ a decision which held unanimously that a *Wall Street Journal* reporter’s stock tips about companies mentioned in his forthcoming “Heard on the Street” columns constituted a fraudulent misappropriation of the *Journal*’s “property” within the meaning of the federal mail and wire fraud statutes.²⁶² The *Carpenter* Court specifically concluded that “[t]he concept of fraud includes the act of embezzlement, which is the fraudulent appropriation to one’s own use of the money or goods entrusted to one’s case by another,”²⁶³ and that the “intangible nature” of

²⁵⁶ *Durenberger*, 48 F.3d at 1241.

²⁵⁷ Clark, *supra* note 201, at 59 n.7. To be sure, each of the fraudulent misappropriation schemes discussed above involved a member of Congress’s allegedly false statements as well as material omissions of fact. Congressman Diggs, for example, was also convicted of making false statements to a U.S. agency (the House of Representatives Office of Finance) in violation of 18 U.S.C. § 1001 (2006). *United States v. Diggs*, 613 F.2d 988, 990-91 (D.C. Cir. 1979). Yet, presumably, the public that Congressman Diggs defrauded of “substantial sums of money,” *id.* at 998, was unaware of the false statements and thus did not rely on them to their detriment. Accordingly, the D.C. Circuit Court’s holding in *Diggs* implicitly recognizes that the public can be defrauded through a congressman’s silence about breaches of trust and loyalty in connection with acts of misappropriation.

²⁵⁸ See *supra* Part I.A.2.

²⁵⁹ *United States v. O'Hagan*, 521 U.S. 642, 652 (1997).

²⁶⁰ *Id.* at 654.

²⁶¹ 484 U.S. 19 (1987).

²⁶² *Id.* at 24.

²⁶³ *Id.* at 27 (internal quotation marks omitted). The *Carpenter* Court also quoted the New York Court of Appeals’ observation that “a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his own personal benefit but must account to his principal for any profits derived therefrom.” *Id.* at 27-28 (quoting *Diamond v. Oreamuno*, 248 N.E.2d 910, 912 (1969)) (internal quotation marks omitted).

information “does not make it any less ‘property.’”²⁶⁴ Yet, while it was unanimous in upholding the defendant’s convictions for mail and wire fraud, the Court had split 4-4 on the validity of the misappropriation theory for purposes of the defendants’ Rule 10b-5 convictions.²⁶⁵ The Court’s subsequent 6-3 endorsement of the misappropriation theory in *O’Hagan* therefore broke the previous Rule 10b-5 deadlock in *Carpenter*.

Yet, prior to the decisions in *O’Hagan* and *Carpenter*, courts, including the Supreme Court, had long-recognized that the secret use of nonpublic government information defrauds the government and its citizens, even though the use of such information had not been viewed as a fraudulent deprivation of property, as such. Indeed, more than a century ago in *Haas v. Henkel*,²⁶⁶ the Supreme Court reviewed an indictment charging the co-defendants with a conspiracy to obtain crop reports from a statistician in the Department of Agriculture “in advance of general publicity, and to use such information in speculating upon the cotton market.”²⁶⁷ The Court concluded that the conspiracy, if proven, would have defrauded “the United States by defeating, obstructing, and impairing it in the exercise of its governmental function in the regular and official duty of publicly promulgating fair, impartial and accurate reports concerning the cotton crop.”²⁶⁸

Several U.S. circuit courts had likewise upheld criminal convictions in cases where the government and its citizens had been “defrauded” by schemes involving the use of nonpublic government information misappropriated for personal profit. A leading decision comes from the Second Circuit in *United States v. Peltz*,²⁶⁹ in which Judge Friendly held that evidence of an agreement to secure nonpublic information from the SEC in order to profit in the stock market supported a jury verdict that the defendant had engaged in an illegal conspiracy to defraud the United States and the SEC.²⁷⁰ In affirming the defendant’s conviction under 18 U.S.C. § 371, Judge Friendly observed that:

Public confidence essential to the effective functioning of government would be seriously impaired by any arrangement that would enable a few individuals to profit from advance knowledge of governmental action. The very making of a plan whereby a government employee will divulge material information which he knows he should not is ‘dishonest’ . . . regardless of whether such plan is secured by consideration.²⁷¹

²⁶⁴ *Id.* at 25.

²⁶⁵ *Id.* at 24 (“The Court is evenly divided with respect to the convictions under the securities laws and for that reason affirms the judgment below on those counts.”).

²⁶⁶ 216 U.S. 462 (1910).

²⁶⁷ *Id.* at 478.

²⁶⁸ *Id.*

²⁶⁹ 433 F.2d 48 (2d Cir. 1970).

²⁷⁰ *Id.* at 49, 52.

²⁷¹ *Id.* at 52 (footnote and citations omitted).

Another important decision is *United States v. Keane*,²⁷² which affirmed a jury verdict convicting a city councilman of violating the federal mail fraud statute in connection with a scheme involving, among other things, the use of “inside information” in the purchase of tax delinquent properties through nominees.²⁷³ The indictment alleged that:

[The] scheme defrauded the city of Chicago, its citizens and Keane’s fellow alderman of their right to the “conscientious, loyal, faithful, disinterested and unbiased services, decisions, actions and performance of official duties” by the defendant and their right to have the City’s business and its affairs conducted “honestly, impartially, free from deceit, craft, trickery, corruption, fraud, undue influence, dishonesty, conflict of interest, unlawful obstruction and impairments, and in accordance with the laws of the State of Illinois and the City of Chicago”²⁷⁴

The Seventh Circuit held explicitly that it was “clearly improper and therefore actionable under the mail fraud statute for the defendant to make use of inside advance information obtained by virtue of his official position for his own personal gain.”²⁷⁵ Citing *Peltz* and two other cases involving securities trading by corporate officials based on confidential corporate information, the court emphasized that those precedents “taken together show that advance dissemination and use of governmental information by a few individuals impairs the functioning of government and that when the use is made by a public official it amounts to a breach of a fiduciary duty which is clearly actionable under the mail fraud statute.”²⁷⁶

The Fourth Circuit’s opinion in *United States v. Bryan*²⁷⁷ is perhaps the most instructive because, having been decided after *Carpenter*, it recognized that a West Virginia Lottery Commission Director’s misappropriation of nonpublic government contract information for his own securities trading purposes can constitute a fraudulent deprivation of “property” belonging to “the citizens of West Virginia,” in addition to a deprivation of their intangible right to receive honest services in violation of the federal wire fraud statute.²⁷⁸ Yet, because

²⁷² 522 F.2d 534 (7th Cir. 1975).

²⁷³ *Id.* at 542.

²⁷⁴ *Id.* at 538-39 (quoting indictment).

²⁷⁵ *Id.* at 545.

²⁷⁶ *Id.*

²⁷⁷ 58 F.3d 933 (4th Cir. 1995).

²⁷⁸ *Id.* at 943. Although the Fourth Circuit’s wire fraud holding was based on an indictment that predicated the charge on the director’s “scheme to defraud the citizens of West Virginia of their right to his honest services” through trading on confidential information, the court cited with a *cf.* the Supreme Court’s decision in *Carpenter* for the proposition that “confidential information is ‘property,’ the deprivation of which can constitute wire fraud.” *Id.* (quoting *Carpenter v. United States*, 484 U.S. 19, 26 (1987)). The fact that the undisclosed misuse of nonpublic information constitutes a deprivation of a property right for purposes of the federal mail and wire fraud statutes is particularly

the Supreme Court in *Carpenter* had split on the validity of the misappropriation theory, the Fourth Circuit in *Bryan* was free to rule that Rule 10b-5 insider trading liability could not be premised on the Director's misappropriation of the nonpublic information concerning the lottery contracts.²⁷⁹ Today, however, in light of the Court's subsequent decision in *O'Hagan*, there should be no question that a government official's securities trading based on nonpublic state lottery information would violate Rule 10b-5. Indeed, such securities trading would defraud the public and the government of their right to the exclusive use of their property.²⁸⁰

Thus, if a court were presented with Congressman B's stock purchases in Company A, compelling precedents support the conclusion that his trading constitutes an undisclosed misappropriation of federal property which operates as a fraud and deceit on the United States and its citizens in violation of Rule 10b-5.²⁸¹ Like the *Wall Street Journal* and its owners, O'Hagan's law firm and its client, and the state and citizens of West Virginia, the United States and its citizens would be deceived and defrauded in connection with the purchase or sale of securities when a person entrusted with material nonpublic information feigns fidelity and exploits that information for his own personal profit. What is key here is that material nonpublic information had been entrusted to Congressman B by the United States and its citizens, even if the information was not explicitly confidential pursuant to a statute, internal rule, or any other specific mandate.²⁸² Nonpublic information about an imminent award of a

important in light of the narrow construction which must now be accorded to § 1346's protection of "the intangible right of honest services." See *Skilling v. United States*, 130 S. Ct. 2896, 2931 (2010) ("[W]e now hold that [18 U.S.C.] § 1346 criminalizes only the bribe-and-kickback core of the pre-*McNally* case law."); see *supra* notes 226-227. Whether profits from trading on the basis of material nonpublic information could be viewed as improper kick-backs for purposes of *Skilling*'s honest-services holding is a question for another day.

²⁷⁹ *United States v. Bryan*, 58 F.3d 933, 943-44 (4th Cir. 1995) (emphasizing that while the misappropriation theory had been embraced by the Second, Seventh, and Ninth Circuits, the Supreme Court was evenly divided in *Carpenter* and thus had yet to rule definitively whether the theory is "reconcilable with the language and purposes of section 10(b) and Rule 10b-5").

²⁸⁰ *Id.* at 943; see also *United States v. ReBrook*, 842 F. Supp. 891, 894 (S.D. W. Va. 1993), *aff'd in part, rev'd in part*, 58 F.3d 961 (4th Cir. 1995) (ruling on an appeal filed in a related prosecution involving an attorney who traded securities based on nonpublic lottery commission information).

²⁸¹ Congressman B's subsequent disclosure of his stock purchases in Company A pursuant to Senate reporting rules would not serve to insulate him from Rule 10b-5 because *O'Hagan* would require disclosure prior to the trade, not after, see *supra* text accompanying note 69, and would require advance disclosure to all persons who are owed a duty of loyalty, see *supra* note 69.

²⁸² Much nonpublic congressional information is nevertheless designated explicitly as "confidential" pursuant to a host of statutes and congressional rules. See George, *supra* note 12, at 166-67.

defense contract by the Appropriations Committee does not belong to a member of Congress any more than nonpublic information about a lottery contract belongs to a state lottery director or nonpublic information about a corporation's possible ore strike belongs to its officers and directors.²⁸³ As fiduciaries, they must hold that nonpublic information in trust for their principals.²⁸⁴

b. *The Federal Government as Employer*

Congressman B's "undisclosed self-serving use" of the Appropriations Committee's information to buy stock in Company A without prior disclosure of his intention to trade could likewise be viewed as a fraud on the federal government as his employer. As previously discussed, an employer and employee stand in a "paradigmatic" fiduciary-like relationship whereby the employee obtains access to information "to serve the ends of" his employer and "becomes duty-bound not to appropriate the property for his own use."²⁸⁵ These principles account for why federal officials formerly with the FBI, the Federal Reserve, the Navy, and the Comptroller of the Currency (and/or their tippees) have all incurred liability for using nonpublic government information to profit personally from securities trading.²⁸⁶ Thus, assuming he can be deemed an employee of the federal government, Congressman B's securities trading would constitute a violation of Rule 10b-5, even under the rather narrow parameters set out by the Second Circuit in *Chestman*.²⁸⁷

²⁸³ See *SEC v. Tex. Gulf Sulphur*, 401 F.2d 833, 848 (2d Cir. 1968).

²⁸⁴ Because this argument regards nonpublic government information as property belonging to the federal government and its citizens, it may hold particular appeal to those courts and scholars who justify the federal insider trading prohibition not on grounds of market integrity or investor confidence but rather on the protection of property rights in information. See, e.g., *United States v. Libera*, 989 F.2d 596, 600 (2d Cir. 1993) ("[T]he purpose of the misappropriation theory . . . is to protect property rights in information."); *United States v. Chestman*, 947 F.2d 551, 576-78 (2d Cir. 1991) (en banc) (Winter, J., concurring in part and dissenting in part) (discussing scholarship by then-Professor Frank Easterbrook). A principal criticism of this rationale has been that it extends Rule 10b-5 protection to property owners in fiduciary relationships with the trader or tipper, even though the beneficiaries of that relationship are not the focus of federal regulation. See, e.g., Roberta S. Karmel, *Outsider Trading on Confidential Information – A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 113 (1998) ("The easiest criticism of the property rights theory is that when Congress passed and subsequently amended the Exchange Act, it was concerned about fairness and the protection of investors, not the protection of property rights in information . . ."). Applying Rule 10b-5 to congressional insider trading is not susceptible to that criticism because the property owners (citizens) are also the principal parties protected by the anti-fraud prohibition (securities investors).

²⁸⁵ *Chestman*, 947 F.2d at 569 (citing RESTATEMENT (SECOND) OF AGENCY § 395 (1958)).

²⁸⁶ See cases cited *supra* notes 100-103.

²⁸⁷ See *supra* notes 109-113 and accompanying text.

Members of Congress receive paychecks from the federal government, so at least in that sense they would seem to qualify as federal employees. Members of Congress have also been deemed employees of the federal government for the purposes of certain statutory protections or grants of immunity.²⁸⁸ On the other hand, several federal statutes draw distinctions “between members of Congress and its officers and employees.”²⁸⁹ Moreover, as one commentator observes, “there is a sense that members of Congress are not like employees because their public election gives them autonomy to make decisions as they see fit without being accountable to anyone but their constituency (and to that extent, only in subsequent elections).”²⁹⁰

The inevitable handwringing that would occur over the question of whether members of Congress are employees of the federal government for purposes of the misappropriation theory is a function of the theory’s reliance on common law to establish the duty of disclosure on which the Rule 10b-5 violation is premised. A loose analogy might be whether an independent contractor can be deemed an agent of the source of material nonpublic information, so that the contractor could be said to owe an inherent obligation of loyalty to his principal.²⁹¹ Ultimately, however, employment status, like agency status, serves as a heuristic that allows courts to find a relationship of trust and confidence that triggers the disclosure obligation in Rule 10b-5 insider trading cases. A court should find that members of Congress owe the United States

²⁸⁸ See, e.g., *Lamar v. United States*, 241 U.S. 103, 111 (1916) (holding that a member of the House of Representatives was an “officer of the government” within the meaning of a penal statute making it a crime to “falsely assume or pretend to be an officer or employee acting under the authority of the United States, or any Department, or any officer of the government thereof” (internal quotation marks omitted)); *Operation Rescue Nat’l v. United States*, 975 F. Supp. 92, 103 (D. Mass. 1997) (holding that Senator Edward Kennedy was an employee of the federal government within the meaning of the Federal Tort Claims Act (FTCA) and was thus entitled to immunity for alleged acts of defamation performed in the course of his employment), *aff’d*, 147 F.3d 68 (1st Cir. 1998). The district court in *Operation Rescue* specifically noted that the FTCA was one of a number of federal statutes treating Senators and Representatives as “employees of the government” and concluded that while Senators and Representatives are “elected by the people,” they are “employed in the legislative branch and, therefore, fit within the literal definition of ‘employee of the government.’” *Id.*

²⁸⁹ *Id.* Significantly, in its Code of Ethics for Government Service, Congress drew no such distinction. See STAFF OF H. COMM. ON STANDARDS OF OFFICIAL CONDUCT, 110TH CONG., HOUSE ETHICS MANUAL 355 (Comm. Print 2008), available at http://ethics.house.gov/Media/PDF/2008_House_Ethics_Manual.pdf (stating that “it is the sense of Congress” that the Code “should be adhered to by all Government employees, including officeholders”).

²⁹⁰ Jerke, *supra* note 12, at 1487. But see *supra* notes 205-233 and accompanying text (discussing accountability through congressional self-discipline and Executive Branch prosecutions).

²⁹¹ See *SEC v. Falbo*, 14 F. Supp. 2d 508, 523 (S.D.N.Y. 1998).

and its citizens a disclosure obligation whether or not a member of Congress is technically a federal employee.

c. *Trust Relationships with Fellow Members and Officials Outside of Congress*

In addition to the United States and its citizens, a member of Congress who uses nonpublic government information in securities trading without disclosing his intention to do so may deceive his fellow members (or other federal officials outside of Congress) who also entrusted him with that nonpublic information. Because this theory would turn on the “reasonable and legitimate expectations” of the relevant parties, analysis would necessarily be ad hoc.²⁹² That is, as instructed by SEC Rule 10b-5(b)(2), a court would question whether the member of Congress and the source of the material nonpublic information “have a history, pattern, or practice of sharing confidences” whereby the member knows, or reasonably should know, that the person communicating the information expects the recipient to maintain its confidentiality.²⁹³ If so, then that relationship provides yet another ground for liability under the misappropriation theory.

Retuning again to Representative Slaughter’s example, Congressman B reasonably should know that the members of the Appropriations Committee expect him to maintain the confidentiality of nonpublic information pertaining to the imminent award of a defense contract. Members of Congress and federal officials from other parts of the government (like the DOD) rely on each other’s loyalty and integrity, and these relationships routinely include “patterns and practices” of exchanging confidences. Accordingly, the members of the Appropriations Committee (or an official at the DOD) would have a “reasonable and legitimate” expectation that nonpublic information about the imminent award of a defense contract would remain confidential and would not be used to enhance the profit in Congressman B’s securities portfolio.²⁹⁴ Thus, in the words of *O’Hagan*, they would be “dupe[d]” or “defraud[ed]”²⁹⁵ were Congressman B to purchase stock in Company A on the basis of this information without first disclosing his intention to do so.

It is possible that Congressman B could contend that members of Congress implicitly condone, or at least tolerate, the use of nonpublic congressional

²⁹² See cases cited *supra* notes 88-95.

²⁹³ SEC Rule 10b-5, 17 C.F.R. § 240.10b5-2(b)(2) (2010).

²⁹⁴ SEC v. Yun, 327 F.3d 1263, 1272 (11th Cir. 2003); see George, *supra* note 12, at 168-69 (“The unilateral decision by a Member or employee to release confidential information is inconsistent with the Senate’s practice of making such decisions openly and collectively. Arrogation of this responsibility by individuals can destroy mutual trust among Members and be harmful to this institution” (quoting 138 CONG. REC. S17835, S17836 (daily ed. Oct. 8, 1992) (statement of Sen. Mitchell))).

²⁹⁵ United States v. O’Hagan, 521 U.S. 642, 654 (1997) (internal quotation marks omitted).

information for personal profit in securities trading. One certainly would hope that this contention would not prove true empirically, and that Congressman B's stock purchases in Company A based on nonpublic information from the Appropriations Committee would instead draw scorn from other members of Congress who would regard such trading as unethical and outrageous. But even in the unlikely event that such information were viewed by other members of Congress as an emolument of office, that view would only negate a finding of deception with respect to his fellow members. It would not negate Congressman B's deception of the United States and its citizens who have had their property misappropriated.

d. *Agreements Not to Use Confidential Information for Personal Gain*

Finally, even if a court were to disregard all of the aforementioned ways in which Congressman B could be found to be in a relationship of trust and confidence with the sources of the material nonpublic information pertaining to Company A, a court might still impute a disclosure duty under Rule 10b-5 from the Code of Ethics for Government Service, which obligates all federal employees including officeholders to “[n]ever use any information coming to [them] confidentiality in the performance of governmental duties as a means for making private profit.”²⁹⁶ As the court maintained in *SEC v. Cuban*, even in the absence of a pre-existing fiduciary-like relationship with the source of material nonpublic information, a person can be held to an agreement “to refrain from trading on or otherwise using [information] for personal gain,”²⁹⁷ and the “subsequent undisclosed use of [that] information for securities trading purposes” would constitute deception in violation of Rule 10b-5.²⁹⁸ The fact that the Code is “not a law under which a Member or staffer can be prosecuted”²⁹⁹ is irrelevant. Indeed, were a court to accept this agreement-not-to-use theory, Congressman B would not be prosecuted for violating the Code of Ethics. Rather, he would be prosecuted for violating Rule 10b-5 and the Code would be used as evidence of his agreement “to refrain from trading on or otherwise using”³⁰⁰ congressional information for personal gain.³⁰¹

²⁹⁶ Code of Ethics for Government Service, H.R. Con. Res. 175, 85th Cong., 72 Stat. B12 (1958).

²⁹⁷ *SEC v. Cuban*, 634 F. Supp. 2d 713, 724 (N.D. Tex. 2009).

²⁹⁸ *Id.*

²⁹⁹ Slaughter Fact Check, *supra* note 150 (“[The Code] is a House Rule, enforceable only by the House Ethics Committee on an internal basis . . .”).

³⁰⁰ *Cuban*, 634 F. Supp. 2d at 725.

³⁰¹ *See* *United States v. Rostenkowski*, 59 F.3d 1291, 1305 (D.C. Cir. 1995) (upholding certain counts of an indictment charging congressman with mail and wire fraud, notwithstanding the fact that “[a]t trial, the Government will almost certainly rely upon House Rules in its effort to prove the statutory violations it has alleged”); *United States v. Diggs*, 613 F.2d 988, 1001 (D.C. Cir. 1979) (“The defendant clearly was tried not for violating the internal rules of the House of Representatives but for violating the mail fraud

Congressman B could raise several arguments in defense. First, he could argue that his obligations under the Code do not amount to an agreement “to refrain from trading” within the meaning of *Cuban*. He could also argue that the *Cuban* decision is an outlier, and that the district court’s reasoning does not comport with the fiduciary principles essential to the Supreme Court’s holdings in prior insider trading cases.³⁰² Finally, he could argue that basing a Rule 10b-5 action on his alleged promise not to use the information would involve issues rendered non-justiciable by the Constitution’s Rulemaking Clause,³⁰³ because that Code provision is “too vague for judicial interpretation.”³⁰⁴ A court would then have to decide whether the Code is “ambiguous” or if it instead provides “judicially discoverable and manageable” standards for interpretation.³⁰⁵ The answer to that question is hardly self-evident.

B. *Education as an Effective SEC Enforcement Tool*

A federal court may not be inclined to agree with each and every one of the above arguments under the classical and misappropriation theories of insider trading liability. But given the tremendously broad range of precedents, and the expansive view of the duty of trust and confidence that has become the norm in insider trading cases, if the SEC were to prosecute Congressman B for violating Rule 10b-5, the SEC would almost certainly be able to establish that multiple persons were deceived and defrauded in connection with his stock purchases in Company A, regardless of whether he obtained the nonpublic defense contract information from the Appropriations Committee or an official at the DOD. The same would be true if Congressman B purchased stock (or options) in Companies X, Y, and Z based on anticipated changes in the tax law or any other market-moving information that the SEC could prove was both material and nonpublic at the time of his trading. Given that Rule 10b-5 imposes on other government officials (as well as on attorneys, family members, electricians, roundtable members, creditors committee members, political consultants, and, of course, corporate insiders) an obligation to refrain from using material nonpublic information in their securities transactions,³⁰⁶ surely it is not unreasonable to hold members of Congress to the same federal

and false statement statutes.”).

³⁰² See *supra* notes 121-122.

³⁰³ See *supra* notes 178-179.

³⁰⁴ *Rostenkowski*, 59 F.3d at 1306.

³⁰⁵ *Id.* (“[J]udicial interpretation of an ambiguous House Rule runs the risk of the court intruding into the sphere of influence reserved to the legislative branch under the Constitution. If a particular House Rule is sufficiently clear that we can be confident in our interpretation, however, then that risk is acceptably low and preferable to the alternative risk that an ordinary crime will escape the reach of the law merely because the malefactor holds legislative office.” (citation omitted)).

³⁰⁶ See cases cited *supra* notes 88-95.

prohibition in an SEC prosecution. Indeed, insider trading defendants routinely are held criminally liable under Rule 10b-5 despite the rule of lenity which requires strict construction of criminal statutes.³⁰⁷

There should be little doubt that a single SEC Rule 10b-5 complaint filed against Congressman B for insider trading would “scare straight” other members of Congress or legislative staffers who may be operating under the misimpression that current law does not extend to securities trading on the basis of nonpublic congressional information.³⁰⁸ But rather than clarifying the law through a targeted enforcement action, it would be far better for the SEC to first state unequivocally that Rule 10b-5’s prohibition against insider trading applies to congressional knowledge in the same manner that it applies to other market-moving information that is both material and nonpublic. Given the claims circulating the media and blogosphere (not to mention in the halls of the Capitol), the SEC should be aggressively seeking to refute the congressional

³⁰⁷ United States v. O’Hagan, 521 U.S. 642, 679 (Scalia, J., concurring in part and dissenting in part) (rejecting the majority’s fraud-on-the-source misappropriation theory because under the “rule of lenity,” section 10(b)’s “unelaborated statutory language . . . must be construed to require the manipulation or deception of a party to a securities transaction”); see Margaret V. Sachs, *Harmonizing Civil and Criminal Enforcement of Federal Regulatory Statutes: The Case of the Securities Exchange Act of 1934*, 2001 U. ILL. L. REV. 1025, 1035 (“[T]he rule of lenity . . . requires strict construction of statutory ambiguities in order to avoid subjecting criminal defendants to surprise.”).

³⁰⁸ Some commentators have even suggested that the publicity generated by the 2004 study on Senate trading profits, Ziobrowski et al., *supra* note 5, may have “scared straight some Capitol Hill types.” John Carney, *Has Congress Been Scared Straight on Insider Trading?*, CNBC (Oct. 12, 2010, 1:33 PM), http://www.cnbc.com/id/39634284/Has_Congress_Been_Scared_Straight_On_Insider_Trading. After his study was published, Professor Ziobrowski heard from other researchers who reported that members of Congress were no longer consistently outperforming other investors in the market in the years following his study. *Id.* He also observed that it is now much easier to track stock holdings of and trading by members of Congress because groups such as the Center for Responsive Politics have searchable databases of lawmakers’ financial disclosures. *Id.* Furthermore, members of Congress may now be more likely to place their investment assets in blind trusts. See JACK MASKELL, CONG. RESEARCH SERV., RS21656, THE USE OF BLIND TRUSTS FOR FEDERAL OFFICIALS 1 (2005) (describing a blind trust as “a device employed by a federal official to hold, administer and manage the private financial assets, investments and ownerships of the official, and his or her spouse and dependant children, as a method of conflict of interest avoidance”). Members of Congress may also be wary about the possibility of private securities litigation. Section 20A of the Exchange Act, 15 U.S.C. § 78t-1 (2006), provides contemporaneous traders with an express right of action against any person who violates any provision of the Exchange Act “by purchasing or selling any security while in possession of material, nonpublic information.” *Id.* Private plaintiffs suing under section 20A need not prove that the defendant owed them a duty of disclosure; rather, to recover a defendant’s illegal gain from insider trading, plaintiffs need only to plead and prove a predicate violation of the Exchange Act, such as a violation of Rule 10b-5. See FERRARA, ET AL., *supra* note 43, at § 3.02.

immunity mantra and should be counseling the sponsors of the STOCK Act as to Rule 10b-5's exceedingly broad scope. A series of speeches or statements to the press would be important first steps toward changing practices in Congress that may have become entrenched but that nonetheless undermine the integrity not only of securities markets but also of government itself. In view of the constitutional and other obstacles that the SEC could encounter while investigating congressional insider trading, education, rather than prosecution, may well be the SEC's most effective enforcement tool.

C. *Legislative Staffers and Other Congressional Employees*

Like Congressman B's securities trading based on nonpublic information about a defense contract, insider trading by a legislative staffer – or any other congressional employee – would violate Rule 10b-5 pursuant to both the classical theory and the misappropriation theory. These individuals work for the members of Congress who were elected to serve the public as Senators and Representatives, and their disclosure obligations under Rule 10b-5 are thus both derivative and direct. As agents for public fiduciaries, legislative staffers and other employees of Congress owe the general public (some of whom are investors trading contemporaneously) the same disclosure duties that are owed by the members or congressional committees who employ them, and their failure to disclose material nonpublic facts in a securities transaction would violate Rule 10b-5 under the classical theory.³⁰⁹ These employees also stand in a direct fiduciary-like relationship with one or more members of Congress and their “undisclosed, self-serving use”³¹⁰ of their employer's information would violate Rule 10b-5 under the misappropriation theory as well.³¹¹ As discussed above, even scholars who have questioned the reach of existing law to members of Congress are quick to conclude that legislative staffers and other congressional employees would be liable under Rule 10b-5 based on the well-established employer-employee misappropriation theory precedents.³¹²

D. *Nonpublic Congressional Information Conveyed Through Tipping*

Given the size and the complexity of the so-called “political intelligence” industry in the United States,³¹³ how the foregoing discussion relates to the

³⁰⁹ See *supra* Part III.A.

³¹⁰ *United States v. O'Hagan*, 521 U.S. 642, 652 (1997).

³¹¹ See *supra* Part III.A-B.

³¹² See Bainbridge, *Beltway I*, *supra* note 12, at 294-95 (“[T]he relationship between the government and one of its employees is such that the undisclosed use by the latter of information gained in the course of his employment would give rise to liability under the misappropriation theory . . . [and the] employment relationship should suffice for Congressional staffers to be deemed to have an agency or other relationship of trust and confidence with their employing agency.”); Lambert, *supra* note 12.

³¹³ For extensive analysis of what has become known as the “political intelligence industry,” see Jerke, *supra* note 12, at 1510-19 (seeking to curb the use of “political

topic of tipping merits an entire article all on its own. For present purposes, though, we can look to the Court's express statements in *Dirks* that a "tippee's duty to disclose or abstain is derivative"³¹⁴ and that a tippee's disclosure obligation under Rule 10b-5 arises "from his role as a participant after the fact in the [tipper's] breach of a fiduciary duty."³¹⁵ Thus, to establish Rule 10b-5 liability on the part of a congressional official for tipping material nonpublic information (as opposed to trading on that information himself), the SEC would have to show that the official breached a fiduciary-like duty for some "direct or indirect personal benefit . . . such as a pecuniary gain or a reputational benefit" or that the official intended to make "a gift of confidential information to a trading relative or a friend."³¹⁶ Moreover, even if the SEC could establish such a breach on the part of the congressional official, his tippee would be liable under Rule 10b-5 only if the SEC could prove that the tippee knew, or should have known, that there had been a breach.³¹⁷

Congressional officials may have a host of reasons for sharing material nonpublic information with others outside Congress.³¹⁸ But under the framework set out by the Court in *Dirks*, Rule 10b-5 liability for illegal tipping and trading would be entirely dependent on the congressional official's motivation for sharing such information. *Dirks*'s "personal benefit" requirement would thus constitute a hurdle in any insider trading case where nonpublic congressional information is alleged to have been used. But just as that hurdle is cleared routinely in tipper-tippee cases outside of Congress (including in several cases involving tips by federal officials),³¹⁹ that hurdle could be overcome in cases involving tips by members of Congress, legislative staffers, and other congressional employees where nonpublic congressional information was conveyed in exchange for a personal benefit.³²⁰

intelligence" through changes in congressional ethics rules rather than through an expanded application of Rule 10b-5).

³¹⁴ *Dirks v. SEC*, 463 U.S. 646, 659 (1983).

³¹⁵ *Id.* (quoting *Chiarella v. United States*, 445 U.S. 222, 230 n.12).

³¹⁶ *Id.* at 663-64. Although some courts disagree, the predominant view is that *Dirks*'s personal benefit requirement applies in both classical and misappropriation theory cases. See FERRARA ET AL., *supra* note 43, at 2-74.

³¹⁷ *Dirks*, 463 U.S. at 660.

³¹⁸ See PAINTER, *supra* note 12, at 167-70 (observing that campaign fundraisers, social events, and official briefings of industry groups are all "venues where government officials can be pumped for nonpublic information" and suggesting that elected officials who share such information may be "behaving very similarly to a tipper who, in return for payment, leaks misappropriated information to a tippee").

³¹⁹ See cases cited *supra* notes 100-103.

³²⁰ See PAINTER, *supra* note 12, at 170 & n.246 (suggesting that, in some circumstances, campaign contributions could be viewed as a personal benefit to elected officials within the meaning of *Dirks*). Of course, in the corporate context, *Dirks*'s personal benefit requirement often prevented the SEC from pursuing Rule 10b-5 actions against persons who had traded securities on the basis of so-called "selective disclosures" that were arguably

CONCLUSION

Congress, the SEC, and the Supreme Court all share in the view that the federal securities laws prohibit the offense of insider trading to promote market integrity and to foster investor confidence in the capital markets. Insider trading on the basis of nonpublic congressional knowledge undermines these important objectives while simultaneously compromising the public's trust and confidence in the government itself.

The conventional wisdom that "it is perfectly legal to profit from information obtained within the Congress,"³²¹ and that members of Congress and legislative staffers are "immune from insider-trading laws"³²² is thus highly problematic. Not only are such statements inaccurate, but they also fuel a troubling public perception that congressional officials are taking advantage of their positions to the public's own detriment and that the SEC is utterly helpless to prevent it. The SEC should be doing more to refute both the flawed legal claims and the public's misperceptions.

The issue of congressional insider trading can serve as a broader object lesson for why the federal securities laws should contain an explicit definition and prohibition of insider trading. But the STOCK Act addresses only a slice of the much larger problem and, ironically, its enactment would likely narrow the general law under Rule 10b-5 that would otherwise apply to insider trading by congressional officials in the absence of a new statute. Unless and until Congress acts to change the law more generally, the classical and misappropriation theories – with their emphasis on duties of entrustment – can function as well for congressional officials as they do for everyone else who trades securities in the capital markets.

motivated by a corporate purpose. See NAGY ET AL., *supra* note 130, at 491-92, 552. Securities analysts and other investment professionals, however, now operate in the wake of Regulation FD, which effectively prohibits public companies and their insiders from selectively disclosing material information to persons who are likely to trade on it, if the information has not been shared with the general public. See SEC Regulation FD, 17 C.F.R. § 243.100(a)-(b)(1) (2010). A Regulation FD analogue for elected officials is an intriguing possibility that warrants further consideration. See PAINTER, *supra* note 12, at 171 (positing a "Regulation FD for government" but contending that it "would be difficult to design and implement").

³²¹ Baird March 2006 Press Release, *supra* note 148.

³²² McGinty & Mullins, *supra* note 9.