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# MISAPPROPRIATING CERTAINTY FROM THE SECURITIES MARKETS: A PRACTITIONER'S PRIMER ON THE *O'HAGAN* DECISION\*

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## I. INTRODUCTION

The government won. The lawyer lost. In the process, two vital prosecutorial weapons against insider trading violations were sustained.

That was the initial read of the Supreme Court's decision in *United States v. O'Hagan*.<sup>1</sup> The *O'Hagan* Court affirmed both the validity of the Securities and Exchange Commission's (SEC) litigation-constructed "misappropriation theory" of Rule 10b-5 liability and the SEC's statutory authority to promulgate Rule 14e-3 under the Securities and Exchange Act of 1934 (Exchange Act). The impact of this outcome, however, extends far beyond the fortunes of one defendant. The manner in which the government prevailed in *O'Hagan* will have significant day-to-day implications for all public companies, asset managers, and the SEC.

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\* This article previously appeared at Harvey L. Pitt & Karl A. Groskaufmanis, *The Supreme Court Has Upheld the Misappropriation Theory, But How Far the SEC Will Take the Ruling Is Anything But Clear*, Nat'l L.J., Aug. 4, 1997, at B4.

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1. 117 S. Ct. 2199 (1997). See, e.g., Edward Felsenthal, *Big Weapon Against Insider Trading is Upheld*, WALL ST. J., June 26, 1997, at C1.

## II. THE O'HAGAN DECISION

James Herman O'Hagan allegedly learned in 1988 that Grand Metropolitan PLC, a client of his law firm, planned to launch a tender offer for the Pillsbury Company. Mr. O'Hagan bought Pillsbury stock and options, generating a tidy \$4.3 million profit when the tender offer was announced. In due course, Mr. O'Hagan drew the attention of the SEC and the local U.S. Attorney. Mr. O'Hagan was subsequently convicted of fifty-seven counts of securities fraud, mail fraud, and money laundering. As a result, Mr. O'Hagan was sentenced to forty-one months in prison.

In a sweeping decision reminiscent of the Supreme Court's expansive interpretations of the federal securities laws in the 1960s and early 1970s,<sup>2</sup> Justice Ruth Bader Ginsburg made short shrift of the objections to the misappropriation theory. Abandoning the Court's literal reading of the federal securities laws, the majority ruled that the misappropriation theory was well within the broad remedial purposes of the Exchange Act. Mr. O'Hagan's attack on his conviction under Rule 14e-3, which forbids certain trading of securities on the basis of material, nonpublic information relating to a tender offer, fared no better. The Court held that, in Section 14(e) of the Exchange Act, Congress expressly delegated to the SEC sufficient authority to promulgate Rule 14e-3. For good measure, the Court upheld Mr. O'Hagan's convictions for mail fraud as well.

## III. PRACTICAL IMPLICATIONS

Many practitioners and their clients perceived *O'Hagan* as a case involving a wayward lawyer. The egregious facts seemed remote based on their experience. On closer reflection, however, the sheer breadth of the majority's decision suggests seven implications that will be important to all public companies and throughout the financial services industry.

*First, O'Hagan will embolden the SEC and the Justice Department to push the envelope on novel securities fraud theories*

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2. See, e.g., Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971); SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963).

*in far less egregious cases.* In shaping the misappropriation theory, the SEC took a calculated gamble that the courts would be more sympathetic to the theory in extreme cases than they would be to a significant line of adverse precedent. The SEC was correct. Ultimately, six members of the Court bought the SEC's theory. Until *O'Hagan*, any expansive reading of the federal securities laws was constrained by the Court's two-decade-old ruling in *Santa Fe Industries v. Green*<sup>3</sup> that Rule 10b-5 could not be used to redress mere breaches of fiduciary duty.<sup>4</sup> In *O'Hagan*, the Court limited *Santa Fe* to a holding that a breach of fiduciary duty is not actionable under Rule 10b-5 if there is full disclosure of all relevant facts.<sup>5</sup>

The lasting impact of *O'Hagan* will be in the difficult "gray" areas in which, to date, the SEC's Enforcement Division has tempered its desire to press enforcement actions. One example of nearly universal relevance relates to perennial concerns regarding the "selective disclosure" of material information by issuers. Beyond the parameters of SEC-mandated disclosure, public companies maintain regular informal contacts with securities analysts, portfolio managers and the financial press. In a volatile marketplace, the earnings "expectations" formed through these contacts become a critical element in the mix of information regarding the company.<sup>6</sup> When the company's spokesperson disseminates key information on a selective basis, one segment of the marketplace is afforded an opportunity to trade directly on the basis of material, nonpublic information.

The SEC's Enforcement Division often chafes on the sidelines when such trading occurs. The SEC's predisposition to prosecute such cases is tempered by its setback in the Supreme Court's 1983 decision in *Dirks v. SEC*.<sup>7</sup> *O'Hagan* did not disturb *Dirks'* requirement that, in a Rule 10b-5 tipping case, the government establish a breach of duty on the part of the tipper.<sup>8</sup>

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3. 430 U.S. 462 (1977).

4. *See id.* at 473-76.

5. *See O'Hagan*, 117 S. Ct. at 2209.

6. *See, e.g.,* E.S. Browning, *Trading Picks Up During Conference Calls, Evidently Leaving Small Investors on Hold*, WALL ST. J., Mar. 6, 1997, at C2; Suzanne McGee, *As Stock Market Surges Ahead, "Predictable" Profits Are Driving It*, WALL ST. J., May 5, 1997, at C1.

7. 463 U.S. 646 (1983).

8. *See id.* at 660-64.

Nonetheless, the breadth of the Court's *O'Hagan* ruling will inspire the SEC's watchdogs to cast a sharper eye at the quarterly dance between issuers and their analysts.<sup>9</sup> The period immediately after *O'Hagan* is an opportune time for counsel at public companies to review internal practices aimed at ensuring broad dissemination of material information.<sup>10</sup>

*Second, asset managers should review internal procedures to be followed when they receive material, nonpublic information about a portfolio company.* The risks associated with selective disclosure also run to the other side of the equation. For example, in its 1996 *Fox-Pitt, Kelton, Inc.* release, the SEC extracted a \$50,000 settlement from a registered broker-dealer whose personnel executed trades on the basis of material, nonpublic information received over the course of an analyst's conference call.<sup>11</sup> The SEC's release did not claim this was illegal insider trading. Instead, the SEC alleged that Fox-Pitt had not satisfied its obligation, under Section 15(f) of the Exchange Act, to maintain procedures reasonably designed to prevent the illegal use of material, nonpublic information. The SEC was not deterred by the considerable legal uncertainty of whether, under *Dirks*, trading on such information is illegal or, for that matter, whether information disseminated broadly to analysts could in any way be considered "nonpublic."

These legal uncertainties provide scant comfort to mutual fund managers, pension fund administrators, and other institutional investors who have little desire to sacrifice their resources and good names to help the SEC frame legal standards through the enforcement process. The best prophylactic measure against such an outcome is an internal regimen that requires personnel involved in asset management to flag situations in which the firm may have received material information on a selective basis. Both the institution and the individual will be less susceptible to the

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9. Presented with the right facts, the SEC has displayed a willingness to authorize such enforcement actions. See *SEC v. Stevens*, Lit. Rel. No. 12813, 48 SEC Dkt (CCH) 739 (Mar. 19, 1991).

10. See generally Harvey L. Pitt & Karl A. Groskaufmanis, *For the Issuer, It's Sometimes Tempting to Provide Analysts with Non-Public Information*, NAT'L L.J., Apr. 18, 1994.

11. See *In re Fox-Pitt, Kelton, Inc.*, Exchange Act Rel. No. 37940, 63 SEC Dkt. (CCH) 452 (Nov. 12, 1996).

enforcement process when the receipt of the information resulted in a careful review of the circumstances.<sup>12</sup>

*Third, Rule 14e-3's validity heightens the need to preserve the confidentiality of deal-related information.* Any time a company is involved in a tender offer, there are compelling business reasons to keep that information secret. A flurry of trading activity in response to inadvertent leaks can scuttle the transaction. *O'Hagan* reinforces the government's strong incentive to prosecute this trading by relying on Rule 14e-3.<sup>13</sup> *O'Hagan* has spared the government the need, in marginal cases, to conduct the mental contortions necessary to "uncover" a duty that has been breached.

In concept, everyone involved in a transaction understands the need to safeguard the sanctity of this potent information. In practice, it often falls on counsel to structure meaningful ground rules to ensure that only a limited number of people with a "need to know" have access to sensitive information. In addition, it is important for counsel to ensure that code words are used in sensitive documents. The temptations associated with this information are legion. In the heat of getting the deal done, it is important to remember that, on many occasions, the SEC or the exchanges will review not only the trading preceding the announcement, but also the practices followed in safeguarding the information.

*Fourth, Rule 14e-3's validity should cause asset managers to revisit the way in which marketplace rumors regarding tender offers are handled within the organization.* Despite everyone's best efforts, putative tender offers often become the source of marketplace rumors. There is no proscription against trading on the basis of such rumors. *O'Hagan*, however, adds to the risks. An institutional investor easily can find itself as the largest single buyer in the waning days before the public announcement of the tender offer. Now is the time to counsel traders and portfolio managers on the distinctions between true market rumors and inadvertent leaks from

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12. For a more detailed discussion see Harvey L. Pitt & Karl A. Groskaufmanis, *Analysis on the Receiving End of an Issuer's Selective Disclosure Need to be Just as Circumspect as Those Who Do the Disclosing*, NAT'L L.J., Apr. 25, 1994.

13. Rule 14e-3(a) proscribes trading on the basis of material, nonpublic information when that information is obtained from the person making a tender offer, the target of the tender offer or anyone acting on behalf of either.

deal participants that might be prosecuted under Rule 14e-3. It also is a good time to reinforce the wisdom of preserving research files so that after the fact a trader can demonstrate that a securities purchase was driven by far more than a single rumor.<sup>14</sup>

*Fifth, by stressing the use of nonpublic information, O'Hagan supports the validity of "Chinese wall" procedures.* Chinese wall procedures are aimed at containing the flow of material, nonpublic information within an organization and are a staple in the securities markets. It is these procedures that allow a multiservice securities firm to continue to trade a security for retail customers while that firm's investment banking arm is completing a material, undisclosed transaction involving the same company. The premise underlying an effective Chinese wall is that the *use* of material, nonpublic information, rather than mere possession, should be the operative standard for insider trading liability.

The SEC consistently has argued that mere "possession" of material, nonpublic information suffices. Thus, if the SEC can show that someone possessed material, nonpublic information, that is enough to warrant a finding of liability. *O'Hagan* undermines the SEC's "possession" theory of insider trading liability. On several occasions, the *O'Hagan* decision stressed that the test for insider trading liability is whether the accused person traded on the basis of material, nonpublic information.<sup>15</sup>

*Sixth, public companies should double their monitoring of personal trading by key corporate insiders.* Corporate officers and directors confront a myriad of traps when they trade their company's securities. At many companies, corporate counsel guide insiders through this regulatory maze. However, this guidance is not solely an act of beneficence. Studies of securities class actions filed since

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14. The availability of such research can be instrumental in deflecting insider trading violations. See Harvey L. Pitt, Karl A. Groskaufmanis & Thomas A. Ferrigno, *Lessons From the Government's Losses: Beyond Moran, Hoover, Adler and Bryan*, INSIGHTS, May 1996, at 16.

15. See, e.g., *United States v. O'Hagan*, 117 S. Ct. 2199, 2209 (1997) (noting that, under the misappropriation theory, "the fiduciary's fraud is consummated . . . when, without disclosure to his principal, he uses the information to purchase or sell securities"); see also *id.* at 2207 ("Under [the misappropriation] theory, 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." (emphasis added)).

the passage of the Private Securities Litigation Reform Act of 1995 reveal an increased proclivity to tie contemporary securities class actions, in part, to allegations of well-timed trades by corporate insiders.<sup>16</sup> Since these cases often end in seven-figure settlements, a company has more than a passing interest in the trading of its senior officers.

The interests of the company and its key personnel can be best protected when their trades are subject to an internal preclearance requirement. Such a regimen can prevent problematic trades and can diminish the government's capacity to claim, after the fact, that insiders intended to violate the federal securities laws. *O'Hagan* reinforced this analysis by observing that a defendant deceives nobody and is not subject to liability if the insider trading has been disclosed to a principal and consent was obtained.<sup>17</sup> Regarding disclosure and consent, the Court was addressing an abstraction because issuers are unlikely to authorize otherwise illegal trading. However, counsel is still diminishing a significant risk by providing an advance review of trades.

Finally, the *O'Hagan* decision may lead to greater SEC emphasis on controlling personal liability for corporations. Section 21A of the Exchange Act vests the SEC with broad authority to seek a penalty against virtually any employer for its lapses in controlling illegal insider trading. While *O'Hagan* suggested that Rule 10b-5 liability could be avoided through consent of the company, the Court also ominously suggested that corporations might be liable with respect to Rule 14e-3 charges if they are aware of, or acquiesce in, a misuse of their own confidential information.<sup>18</sup> The SEC can be expected to place greater emphasis on the steps companies take to monitor improper trading by employees and the steps they take to redress such misconduct when trading of that nature occurs.

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16. See Office of the General Counsel, Securities and Exchange Commission, Report to the President and the Congress on the First Year of Practice Under the Private Securities Litigation Reform Act of 1995, 22 (Apr. 1997) (noting that 48% of class action complaints are premised, in part, on allegations of illegal insider trading).

17. See *O'Hagan*, 117 S. Ct. at 2208, 2211 n.9.

18. See *id.* at 2211 n.9.

## IV. CONCLUSION

Few of these issues were aired in the briefing and oral argument in the *O'Hagan* case because the government deftly picked the right case to test the misappropriation theory. The majority opinion wasted little time in noting that the illegal trading was intended to generate profits to conceal previous embezzlement from client trust funds and that Mr. O'Hagan had been disbarred, convicted and sentenced by a state court for these defalcations.<sup>19</sup> James O'Hagan evoked little sympathy.

The outcome of Mr. O'Hagan's appeal is that the government and the courts will remain free to make up insider trading law as they go along. As the enforcement process is used to craft rules for public companies and market participants, good people trying to do the right thing nonetheless will get enmeshed in the litany of subpoenas and testimony under oath. That is not necessarily the best way to set the rules for our securities markets. But it remains the *status quo* after the *O'Hagan* decision.

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19. See *id.* at 2205 & n.2 (citing *In re O'Hagan*, 450 N.W.2d 571 (Minn. 1990); *State v. O'Hagan*, 474 N.W.2d 613 (Minn. App. 1991)).