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"Disclose-or-Abstain" Without Restraint: The Supreme Court Misses the Mark on Rule 14e-3 in *United States v. O'Hagan*

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"Disclose-or-Abstain" Without Restraint: The Supreme Court Misses the Mark on Rule 14e-3 in *United States v. O'Hagan*

E. Livingston B. Haskell*

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I. Introduction

In 1980, the Securities and Exchange Commission (SEC) promulgated Rule 14e-3¹ pursuant to the authority that Congress granted to it in Section 14(e) of the Securities Exchange Act of 1934 (the Act).² Rule 14e-3 mandates that a person who possesses material nonpublic information relating to a tender offer³ must either disclose the information or abstain from trading in the affected stock.⁴ On August 2, 1996, in *United States v. O'Hagan*,⁵ the United States Court of Appeals for the Eighth Circuit determined that the SEC exceeded its authority under the Act by promulgating Rule 14e-3 without including a breach of fiduciary duty requirement for nondisclosure cases.⁶ The Eighth Circuit's ruling conflicted directly with decisions from the United

1. 17 C.F.R. § 240.14e-3(a) (1997).

2. Securities Exchange Act of 1934 § 14(e), 15 U.S.C. § 78n(e) (1994).

3. See Samuel N. Allen, Note, *The Scope of the Disclosure Duty Under SEC Rule 14e-3*, 38 WASH. & LEE L. REV. 1055, 1055 n.2 (1981) (defining tender offer as "a method of corporate takeover in which a bidder offers to purchase shares of a target corporation at a premium price provided the target's shareholders sell a specified number of shares" (citing *Takeover Bids: Hearing on H.R. 14475 and S. 510 Before the Subcomm. on Commerce and Fin. of the House Comm. on Interstate and Foreign Commerce*, 90th Cong. 11 (1968) [hereinafter *1968 House Hearings*] (statement of Manuel F. Cohen, SEC Chairman))).

4. See *SEC v. Maio*, 51 F.3d 623, 635 (7th Cir. 1995) (noting that "Rule 14e-3 creates a duty to disclose material non-public information, or abstain from trading in stocks implicated by an impending tender offer, regardless of whether such information was obtained through a breach of a fiduciary duty"); *United States v. Chestman*, 947 F.2d 551, 557 (2d Cir. 1991) (en banc) (stating that "[o]ne violates Rule 14e-3(a) if he trades on the basis of material nonpublic information concerning a pending tender offer that he knows or has reason to know has been acquired 'directly or indirectly' from an insider of the offeror or issuer, or someone working on their behalf" and that rule "creates a duty in those traders who fall within its ambit to abstain or disclose, without regard to whether the trader owes a pre-existing fiduciary duty to respect the confidentiality of the information"); see also *SEC v. Peters*, 978 F.2d 1162, 1165 (10th Cir. 1992) (quoting *Chestman*, 947 F.2d at 557).

5. 92 F.3d 612 (8th Cir. 1996).

6. See *United States v. O'Hagan*, 92 F.3d 612, 627 (8th Cir. 1996) (stating that "the SEC exceeded its rulemaking authority under § 14(e) when it promulgated Rule 14e-3(a) without including a requirement of a breach of a fiduciary obligation"), *rev'd*, 117 S. Ct. 2199 (1997).

States Courts of Appeals for the Second,⁷ Seventh,⁸ and Tenth Circuits,⁹ which all found Rule 14e-3 to be a valid exercise of the SEC's Section 14(e) rulemaking authority.¹⁰ On June 25, 1997, the Supreme Court settled the longstanding conflict,¹¹ reversing the Eighth Circuit's ruling in *O'Hagan* and

7. See *Chestman*, 947 F.2d at 559 (stating that promulgating Rule 14e-3 was within SEC's authority under Section 14(e)).

8. See *Maio*, 51 F.3d at 635 (stating that promulgating Rule 14e-3 was within SEC's authority under Section 14(e)).

9. See *Peters*, 978 F.2d at 1165 (stating that promulgating Rule 14e-3 was within SEC's authority under Section 14(e)).

10. Compare *O'Hagan*, 92 F.3d at 614 (finding that SEC exceeded its Section 14(e) rulemaking authority when it promulgated Rule 14e-3 and "omitted therefrom the requirement that a breach of a fiduciary duty must be shown in order to violate the rule"), with *SEC v. Maio*, 51 F.3d 623, 635 (7th Cir. 1995) ("Rule 14e-3 creates a duty to disclose material nonpublic information, or abstain from trading in stocks implicated by an impending tender offer, regardless of whether such information was obtained through a breach of a fiduciary duty."), *SEC v. Peters*, 978 F.2d 1162, 1165 (10th Cir. 1992) (stating that "Rule 14e-3, as written - i.e., with no fiduciary duty requirement - is within the SEC's statutory rulemaking authority"), and *United States v. Chestman*, 947 F.2d 551, 562 (2d Cir. 1991) (en banc) (asserting that Rule 14e-3 "creates a duty in those traders who fall within its ambit to abstain or disclose, without regard to whether the trader owes a pre-existing fiduciary duty to respect the confidentiality of the information").

11. Compare Dennis J. Block & Nancy E. Barton, *Securities Litigation: Insider Trading - The Need for Legislation*, 10 SEC. REG. L.J. 350, 365-67 (1983) (questioning validity of Rule 14e-3 based on relationship with Section 10(b) and Supreme Court decision in *Chiarella v. United States*, 445 U.S. 222 (1980)), and Douglas M. Branson, *Discourse on the Supreme Court Approach to SEC Rule 10b-5 and Insider Trading*, 30 EMORY L.J. 263, 281 n.93 (1981) (debating whether Rule 14e-3 could withstand Supreme Court scrutiny), and Samuel H. Gruenbaum, *Acquisitions and Mergers: The New Disclose or Abstain from Trading Rule*, 4 CORP. L. REV. 350, 352-55 (1981) (asserting that SEC's promulgation of Rule 14e-3 may not be legal), and Harry Heller, Chiarella, *SEC Rule 14e-3 and Dirks: "Fairness" Versus Economic Theory*, 37 BUS. LAW. 517, 546 (1982) (questioning legality of Rule 14e-3 after *Chiarella*), and Janell M. Kurtz & Bradley J. Sleeper, *Fraud Liability for Outsider Trading: SEC Rule 14e-3 in Limbo*, 29 AM. BUS. L.J. 691, 693 (1992) (arguing that Rule 14e-3 is invalid based on Supreme Court's holdings in *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985) and *Chiarella*), and Richard M. Phillips, *Insider Trading Liability After Dirks*, 16 REV. SEC. REG. 841, 847-48 (1983) (contending that Rule 14e-3 conflicts with holdings of *Chiarella* and *Dirks v. SEC*, 463 U.S. 646, 665 (1983)), and William K.S. Wang, *Recent Developments in the Federal Law Regulating Stock Market Inside Trading*, 6 CORP. L. REV. 291, 306-08 (1983) (describing unsettled issue of legality of Rule 14e-3), and Allen, *supra* note 3, at 1062-65 (concluding that Congress did not intend to regulate corporate outsiders through Williams Act or its amendments), and William J. Cook, Note, *From Insider Trading to Unfair Trading: Chestman II and Rule 14e-3*, 22 STETSON L. REV. 171, 208 (1992) (claiming Rule 14e-3 is outside SEC's authority), and Mary F. Hill, Note, *Trading on Material, Nonpublic Information Under Rule 14e-3*, 49 GEO. WASH. L. REV. 539, 556-57 (1981) (acknowledging that Supreme Court may not be sympathetic to Rule 14e-3), and Mark A. Kahrs, Note, *Is the Securities and Exchange Commission Overreaching its Rulemaking Authority Under Rule 14e-3?*, 30 WASHBURN

finding that Rule 14e-3 was consistent with its enabling statute.¹²

In reaching its conclusion, the Supreme Court ignored a fundamental rule of administrative law by evaluating the validity of Rule 14e-3 on a basis other than the one that the SEC provided at the time of the original rulemaking action.¹³ When the SEC promulgated Rule 14e-3, it claimed that it was exerting its alleged power under Section 14(e) to redefine "fraud" in the tender offer context.¹⁴ The Court, however, reviewed the SEC's action under the assumption that the SEC had applied "prophylactic" rulemaking authority under Section 14(e).¹⁵ Based on the premise that the SEC possesses the power to regulate acts that are not themselves fraudulent as a reasonable means to prevent acts that are fraudulent, the Court found Rule 14e-3 to be valid.¹⁶ In so doing, the Court impermissibly altered the traditional framework for analyzing the validity of agency action by employing a post hoc rationalization to justify the SEC's rulemaking.¹⁷

This Note explores the Supreme Court's flawed analysis in *O'Hagan* and presents an evaluation of the validity of Rule 14e-3 under the appropriate interpretive framework. Part II of this Note discusses the foundation for the

L.J. 300, 323 (1991) (alleging that SEC's promulgation of Rule 14e-3 violates its statutory authority), *with* *United States v. Marcus Schloss & Co.*, 710 F. Supp. 944, 955-57 (S.D.N.Y. 1989) (finding that Rule 14e-3 falls within Congress's broad delegation of rulemaking authority to SEC), *and* *United States v. Chestman*, 704 F. Supp. 451, 454-58 (S.D.N.Y. 1989) (same), *rev'd*, 903 F.2d 75 (2d Cir. 1990), *vacated in part en banc*, 947 F.2d 551 (2d Cir. 1991), *and* Susan Lorde Martin, *Insider Trading and Rule 14e-3 After Chestman*, 29 AM. BUS. L.J. 665, 668 (1992) (arguing that SEC was within its authority when it promulgated Rule 14e-3).

12. *See* *United States v. O'Hagan*, 117 S. Ct. 2199, 2219 (1997) (reversing Eighth Circuit's ruling and upholding validity of Rule 14e-3).

13. *See* *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1946) (describing principle that courts can only review agency action on basis that agency stated as "simple but fundamental rule of administrative law").

14. *See O'Hagan*, 117 S. Ct. at 2228 (Thomas, J., dissenting) (asserting that "the Rule, on its face, does not purport to be an exercise of the Commission's prophylactic power, but rather a redefinition of what 'constitute[s] a fraudulent, deceptive, or manipulative act or practice within the meaning of § 14(e)'" (quoting 17 C.F.R. § 240.14e-3(a) (1997))). *But see id.* at 2218 n.19 ("Logically and practically, such a rule may be conceived and defended, alternatively, as definitional or preventive.").

15. *See id.* at 2217 (deciding not to address defining power argument and instead looking to Government's prophylactic power rationale).

16. *See id.* at 2219 (finding that "Rule 14e-3(a) is a proper exercise of the Commission's prophylactic power under § 14(e)"). *But see id.* at 2228 (Thomas, J., dissenting) (contending that prophylactic argument fails on merits).

17. *See id.* at 2228 (Thomas, J., dissenting) ("We evaluate regulations not based on the myriad of explanations that could have been given by the relevant agency, but on those explanations and justifications that were, in fact, given."); *see also Chenery*, 332 U.S. at 196 (stating that courts must review agency action based upon grounds that agency provided).

delegation of power from Congress to administrative agencies and the traditional analytical structure for assessing whether a particular rule extends invalidly beyond an agency's enabling statutes.¹⁸ In Part III, this Note examines the debate surrounding Rule 14e-3 by addressing the legislative history of Section 14(e), the relevance of Rule 10b-5 and Section 10(b) of the Act,¹⁹ and the split between United States Circuit Courts of Appeals over the validity of Rule 14e-3.²⁰ Part IV discusses the majority opinion of the Supreme Court in *O'Hagan*²¹ and its problematic new test for evaluating agency compliance with enabling statutes.²² Part V provides an assessment of the validity of Rule 14e-3 under the proper analytical framework.²³

II. Delegation of Power from Congress to Agencies

The first sentence of the body of the Constitution provides: "All legislative Powers herein granted shall be vested in a Congress of the United States . . ." ²⁴ The Supreme Court has held that Congress nevertheless may delegate this constitutional power.²⁵ By dispensing authority to administrative agencies, Congress utilizes the expertise of these agencies, conserves congressional resources, and maintains legislative flexibility in the face of changing conditions and technology.²⁶ This capacity to delegate power, however, is not unlimited; Congress must fix the "primary standard" under which its delegatee may act.²⁷ Administrative agencies, therefore, as Congress's delegates, derive

18. See *infra* notes 24-40 and accompanying text (discussing delegation of authority from Congress to administrative agencies and outlining steps for determining validity of agency action).

19. See *infra* notes 41-80 and accompanying text (presenting general legislative history of § 14e-3 and Rule 14e-3 and analyzing their relationship with Section 10(b) and Rule 10b-5).

20. See *infra* notes 81-148 and accompanying text (discussing circuit court cases that created split over validity of Rule 14e-3).

21. See *infra* notes 149-60 and accompanying text (analyzing Supreme Court opinion in *O'Hagan*).

22. See *infra* notes 161-87 and accompanying text (challenging legitimacy of "new test" for evaluating validity of agency action and critiquing Court's application of test).

23. See *infra* notes 188-271 and accompanying text (presenting test of compliance of Rule 14e-3 with enabling statute using traditional analysis).

24. U.S. CONST. art. I, § 1.

25. See *Wayman v. Southard*, 23 U.S. (10 Wheat.) 1, 43 (1825) (stating that "Congress may certainly delegate to others, powers which the legislature may rightfully exercise itself").

26. See ALFRED C. AMAN, JR. & WILLIAM T. MAYTON, *ADMINISTRATIVE LAW* 10-12 (1993) (describing benefits of delegation to agencies).

27. See *United States v. Shreveport Grain & Elevator Co.*, 287 U.S. 77, 85 (1932) (stating that "Congress may declare its will, and after fixing a primary standard, devolve upon administrative officers the 'power to fill up the details'").

their power solely from express congressional grants of authority limited by the primary standard set out in their enabling statutes.²⁸ An agency's power to create rules is not the power to make law.²⁹ Instead, the delegation of rulemaking authority requires an agency to implement the expressed will of Congress.³⁰ Courts concordantly strike down agency action that is inconsistent with the applicable enabling statute as *ultra vires*.³¹ Nonetheless, courts may grant "more than mere deference or weight" to an agency's interpretation of its own administrative authority.³²

28. See BERNARD SCHWARTZ, *ADMINISTRATIVE LAW: A CASEBOOK* 75 (4th ed. 1994) (stating that "statute is the source of agency authority as well as of its limits"); see also *Lyng v. Payne*, 476 U.S. 926, 937 (1986) (stating that agency may not exceed power delegated in enabling statute).

29. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 213 (1976) ("The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law."). Without this limitation, an agency would possess unbridled authority to confer power upon itself and to "override Congress." See *Louisiana Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 374-75 (1986) (describing repercussion of allowing agencies to act in excess of enabling statute).

30. See *Dixon v. United States*, 381 U.S. 68, 74 (1965) (stating that enabling statutes grant agencies "the power to adopt regulations to carry into effect the will of Congress as expressed by the statute" (quoting *Manhattan Gen. Equip. Co. v. Commissioner*, 297 U.S. 129, 134 (1936))).

31. See Administrative Procedure Act § 10(e)(2)(C), 5 U.S.C. § 706(2)(C) (1994) (providing mechanism for courts to review and to set aside agency action in excess of statutory authority); *Transohio Sav. Bank v. Director, Office of Thrift Supervision*, 967 F.2d 598, 621 (D.C. Cir. 1992) (finding that courts must invalidate action beyond delegated authority); *Steele v. FCC*, 770 F.2d. 1192, 1194 (D.C. Cir. 1985) (providing that judge must make ultimate determination); Bernard Schwartz, *Administrative Law Cases During 1995*, 48 ADMIN. L. REV. 399, 406 (1996) (characterizing truism that regulations may not be *ultra vires* of enabling statute as "basic"). An administrative agency exceeds its statutory authority if it promulgates a rule that is "inconsistent with the statutory mandate or frustrate[s] the policy Congress sought to implement." *Securities Indus. Ass'n v. Board of Governors*, 468 U.S. 137, 143 (1984) (quoting *FEC v. Democratic Senatorial Campaign Comm.*, 454 U.S. 27, 32 (1981)).

32. See *Batterton v. Francis*, 432 U.S. 416, 424-26 (1977) (describing substantial deference courts should give to agency's application of statutory authority); see also *Mississippi Power & Light Co. v. Mississippi ex rel. Moore*, 487 U.S. 354, 381 (1988) (Scalia, J., concurring) (stating that "it is plain that giving deference to an administrative interpretation of its statutory jurisdiction or authority is both necessary and appropriate"); *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843-44 (1984) (stating that when "Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation" and that "such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute"); *NLRB v. City Disposal Sys., Inc.*, 465 U.S. 822, 830 n.7 (1984) (noting that Court has never found exception to normal deference owed to agency for situations when NLRB interprets coverage of its own enabling act). But see *Board of Governors, FRS v. Dimension Fin. Corp.*, 474 U.S. 361, 368 (1986) ("The traditional deference

Courts apply a two-step test when they review an agency's construction of its enabling statute.³³ First, a reviewing court must evaluate whether the agency's action and interpretation are in accord with Congress's intent in passing the enabling provision.³⁴ To determine Congress's intent, courts apply "traditional tools of statutory construction;"³⁵ specifically, courts look to the language of the statute,³⁶ the legislative history behind the statute,³⁷ and the policy behind the statute.³⁸ Second, if the intent of Congress is unclear, a court must determine if the agency's action represented a reasonable construction of the enabling provision.³⁹ In applying this two-pronged test, a court

courts pay to agency interpretation is not to be applied to alter the clearly expressed intent of Congress."); Cass R. Sunstein, *Constitutionalism After the New Deal*, 101 HARV. L. REV. 421, 467 (1987) (arguing that deference to administrators with regard to their own authority violates principles of separation of powers); Eric M. Braun, Note, *Coring the Seedless Grape: A Reinterpretation of Chevron U.S.A. Inc. v. NRDC*, 87 COLUM. L. REV. 986, 1005-06 (1987) (asserting that courts should not defer to agencies when situation involves "agency aggrandizement"). "A reviewing court is not free to set aside those regulations simply because it would have interpreted the statute in a different manner." *Batterton*, 432 U.S. at 425. An administrative rule may be set aside "only if the [agency] exceeded [its] statutory authority or if the regulation is 'arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.'" *Id.* at 426 (quoting 5 U.S.C. §§ 706(2)(A), (C)).

33. See *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842 (1984) (outlining two-pronged test for review of agency construction of enabling statute).

34. See *id.* at 842-43 ("First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.").

35. *Id.* at 843 n.9; see also *INS v. Cardoza-Fonseca*, 480 U.S. 421, 446 (1987) (applying "traditional tools of statutory construction" to assess congressional intent in validity of agency action case).

36. See *Chevron*, 467 U.S. at 859-62 (addressing statutory language to determine congressional intent); see also *K Mart Corp. v. Cartier, Inc.*, 486 U.S. 281, 291 (1988) (stating that reviewing court first must look to plain meaning of statute, particular statutory language in question, and language and design of statute in entirety); *United States v. Menasche*, 348 U.S. 528, 538-39 (1955) (stating that courts must "give effect, if possible, to every clause and word of a statute" when they address language to determine intent of Congress (quoting *Montclair v. Ramsdell*, 107 U.S. 147, 152 (1882))).

37. See *Chevron*, 467 U.S. at 862-64 (discussing legislative history to determine congressional intent); see also *K Mart*, 486 U.S. at 300 (same); *Cardoza-Fonseca*, 480 U.S. at 449 (same).

38. See *Chevron*, 467 U.S. at 864-66 (1984) (considering policy behind statute to determine congressional intent); see also *K Mart*, 486 U.S. at 300 (looking to purpose of statute to determine congressional intent).

39. See *Chevron U.S.A. Inc., v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843 (1984) (stating that "if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute").

must review the agency's action based on the reasoning that the agency provided.⁴⁰

III. *The Debate over the Validity of Rule 14e-3*

A. *Section 14(e), Rule 14e-3, and Their Relation to Section 10(b) and Rule 10b-5*

In the aftermath of the 1929 stock market crash, Congress enacted Section 10(b) of the Act⁴¹ as part of a wave of federal legislation intended to address the insufficiency of the common law in protecting investors from insider trading.⁴² Section 10(b) grants the SEC power to regulate manipulative or deceptive devices connected with securities transactions in an attempt to preserve the public interest and to protect investors.⁴³ Based on this authority, the SEC promulgated Rule 10b-5,⁴⁴ a general antifraud provision that the

40. See *SEC v. Chenery Corp.*, 332 U.S. 194, 196 (1947) (noting fundamental principle of administrative law). The Supreme Court stated:

[A] reviewing court, in dealing with a determination or judgment which an administrative agency alone is authorized to make, must judge the propriety of such action solely by the grounds invoked by the agency. If those grounds are inadequate or improper, the court is powerless to affirm the administrative action by substituting what it considers to be a more adequate or proper basis.

Id.

41. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994). Section 10(b) of the Act states:

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange –

....

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

42. See Sean P. Leuba, Note, *The Fourth Circuit Breaks Ranks in United States v. Bryan: Finally, a Repudiation of the Misappropriation Theory*, 53 WASH. & LEE L. REV. 1143, 1152-53 (1996) (describing impetuses behind enactment of Securities Act of 1933 and Act).

43. 15 U.S.C. § 78j(b) (1994).

44. 17 C.F.R. § 240.10b-5 (1997). Rule 10b-5 states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a

SEC utilizes to enforce the prohibition on insider trading.⁴⁵ Rule 10b-5 proscribes the employment of schemes to defraud, the communication of misleading statements, and the engagement in fraudulent or deceitful acts.⁴⁶

In March 1980, the Supreme Court found in *Chiarella v. United States*⁴⁷ that parties in securities transactions cannot violate Rule 10b-5 due to their nondisclosure of material nonpublic information unless there is a breach of a fiduciary or confidential relationship between the parties to the transaction.⁴⁸ The Court looked to the common-law use of the word "fraud" to determine the scope of the powers that Congress delegated to the SEC in Section 10(b).⁴⁹ Accordingly, the Court found that "one who fails to disclose material information prior to consummation of a transaction commits fraud only when he is under a duty to do so."⁵⁰ In *Chiarella*, petitioner Vincent Chiarella acquired nonpublic material information through his employment with a financial printer and purchased stock based on the information.⁵¹ Chiarella, as a corporate outsider⁵² and complete stranger to the sellers of the stock, had no duty

material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit on any person, in connection with the purchase or sale of any security.

Id.

45. See Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CAL. L. REV. 1, 2 (1982) (discussing SEC's use of Section 10(b) and Rule 10b-5 to enforce prohibition against insider trading).

46. See *supra* note 44 (providing text of Rule 10b-5).

47. 445 U.S. 222 (1980).

48. *Chiarella v. United States*, 445 U.S. 222, 230-35 (1980) (finding that duty to disclose under Rule 10b-5 arises only when fiduciary duty exists between parties to transaction). Vincent Chiarella worked as a "markup man" in the New York composing room of Pandick Press, a financial printer. *Id.* at 224. During the course of his employment, Chiarella handled printing work for four corporate takeover bids and a corporate merger. *Id.* & n.1. Although the names of the parties to the takeovers were concealed until the night of the final printing, Chiarella was able to determine the identities of the target corporations from other information in the preliminary copies of the documents. *Id.* Based on this knowledge and without disclosing the information, Chiarella purchased shares of the target companies prior to the public announcement of the takeover attempts and sold them immediately thereafter. *Id.* Using this scheme over the course of fourteen months, Chiarella reaped gains of more than \$30,000. *Id.* Subsequently, the government indicted Chiarella on seventeen counts of violating Section 10(b) and Rule 10b-5. *Id.* at 225. Chiarella was tried and convicted on all counts. *Id.* The Second Circuit rejected his appeal. *Id.*

49. *Id.* at 227-28.

50. *Id.* at 228.

51. *Id.* at 224.

52. See *id.* at 231-33 (stating that Chiarella was not corporate insider and thus had no

to disclose the information to the sellers because he was not their agent, fiduciary, or an individual in whom they placed their trust.⁵³ The Court reversed Chiarella's convictions because, "[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak."⁵⁴ A Rule 10b-5 conviction for nondisclosure in the absence of a breach of a fiduciary duty between securities transaction participants "would be inconsistent with the careful plan that Congress has enacted for regulation of the securities markets."⁵⁵ The Supreme Court followed *Chiarella's* reasoning three years later in *Dirks v. SEC*.⁵⁶

affirmative duty to disclose information). In determining the definition of "insider" for the purpose of establishing identities of those to whom Rule 10b-5 applies, Justice Powell, the author of the *Chiarella* opinion, stated that "[t]he Commission emphasized that the duty arose from (i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure." *Id.* at 227 (citing *In re Cady Roberts & Co.*, 40 S.E.C. 907, 912 & n.15 (1961)).

53. *Id.* at 232-33.

54. *Id.* at 235.

55. *Id.* at 235. The Court noted that "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. . . . [T]here can be no fraud [based on nondisclosure] absent a duty to speak." *Id.* at 234-35.

56. See *Dirks v. SEC*, 463 U.S. 646, 665 (1983) (finding that there can be no violation of Rule 10b-5 for nondisclosure without breach of fiduciary duty). Raymond Dirks was working for a New York broker-dealer firm when Ronald Secrist approached him with information about a corporation named Equity Funding of America (Equity Funding). *Id.* at 648-49. Secrist, a former Equity Funding officer, told Dirks that Equity Funding's corporate assets were overstated due to fraudulent corporate tactics. *Id.* at 649. Secrist urged Dirks to research the allegations and expose the fraud. *Id.* Dirks traveled to Equity Funding's headquarters in Los Angeles where the management of the corporation denied any fraud, but other employees confirmed Secrist's allegations. *Id.* Dirks urged William Blundell, Los Angeles bureau chief of the Wall Street Journal, to expose the fraud, but Blundell refused. *Id.* at 649-50. During Dirks' two-week investigation, he spoke with a number of clients and investors, including some who had holdings in Equity Funding, about the information he had uncovered. *Id.* at 649. Among the people with whom Dirks spoke, five were investment advisors who liquidated more than \$16 million in Equity Funding securities. *Id.* Neither Dirks nor his firm owned or traded any Equity Funding securities during this time. *Id.* Over the course of Dirks's investigation, Equity Funding's stock price fell from \$26 per share to less than \$15 per share before the SEC halted trading. *Id.* at 650. Subsequently, California insurance authorities uncovered evidence of fraud in Equity Funding's records, the SEC filed a complaint, and the *Wall Street Journal* published the story on the front page. *Id.* The SEC also investigated Dirks and found that by relaying the allegations of fraud to the investment community, he violated various securities laws, including Rule 10b-5. *Id.* at 650-51. On review, the United States Court of Appeals for the District of Columbia Circuit entered judgment against Dirks for the reasons the SEC stated. *Id.* at 652. The Supreme Court, however, reversed Dirks's conviction. *Id.* at 667. In an opinion written by Justice Powell (the author of the *Chiarella* opinion), the Court found that Dirks could not violate Rule 10b-5 absent a duty to disclose or abstain from

In response to the Supreme Court's *Chiarella* decision,⁵⁷ the SEC asserted its Section 14(e)⁵⁸ rulemaking authority and promulgated Rule 14e-3.⁵⁹

use of the inside information. *Id.* The Court reasoned that failing to require a breach of a fiduciary duty would impose "a general duty between all participants in market transactions to forgo actions based on material, nonpublic information." *Id.* at 654-55 (quoting *Chiarella v. United States*, 445 U.S. 222, 233 (1980)). The creation of such a general duty would "depar[t] radically from the established doctrine that duty arises from a specific relationship between two parties." *Id.* at 654-55 (quoting *Chiarella*, 445 U.S. at 233).

57. See Wang, *supra* note 11, at 308 (finding that SEC promulgated Rule 14e-3 in response to *Chiarella*); Hill, *supra* note 11, at 539 (same).

58. Securities Exchange Act of 1934 § 14(e), 15 U.S.C. § 78n(e) (1994). Section 14(e) of the Act states:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

Id. Section 14(e), consistent with the general rulemaking power that Section 23(a)(1) of the Act authorizes, grants the SEC authority to create rules and regulations for the purpose of preventing insider trading violations relating to tender offers. See *United States v. Chestman*, 947 F.2d 551, 556-57 (2d Cir. 1991) (en banc) (asserting that Sections 14(e) and 23(a)(1) are enabling statutes for Rule 14e-3). Section 23(a)(1) authorizes the SEC "to make such rules and regulations as may be necessary or appropriate to implement the provisions of this chapter for which [it is] responsible or for the execution of the functions vested in [it] by this chapter." 15 U.S.C. § 78w(a)(1) (1997).

59. 17 C.F.R. § 240.14e-3(a) (1997). Rule 14e-3(a) states:

(a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of Section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

- (1) The offering person,
- (2) The issuer of securities sought or to be sought by such tender offer, or
- (3) Any officer, director, partner, or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

Id.

Congress enacted the first sentence of Section 14(e) in 1968 as part of the Williams Act,⁶⁰ with the purpose of providing investors with full disclosure for tender offers.⁶¹ In so doing, Congress strove to protect market participants from unfair trading practices.⁶² Congress added the second sentence of Sec-

60. Williams Act, Pub. L. No. 90-439, sec. 3(e), § 14(e), 82 Stat. 454, 457 (1968) (codified at 15 U.S.C. § 78n(e) (1994)).

61. See S. REP. NO. 90-550, at 3 (1967) (noting that purpose of bill was to provide investors with full and fair disclosure in tender offer situations); H.R. REP. NO. 90-1711, at 4 (1968), reprinted in 1968 U.S.C.C.A.N. 2811, 2813 (finding that "[w]hile the bill may discourage tender offers or other attempts to acquire control by some who are unwilling to expose themselves to the light of disclosure, the committee believes this is a small price to pay for adequate investor protection"); *Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids: Hearings on S. 510 Before the Subcomm. on Securities of the Senate Committee on Banking and Currency*, 90th Cong. 44 (1967) [hereinafter *1967 Senate Hearings*] (statement of Sen. Kuchel) (asserting that purpose of bill was to insure disclosure of adequate information to investors); 113 CONG. REC. 854, 854-55 (1967) (statement of Sen. Williams) (outlining twin policies of Williams Act by stating that "[t]he purpose of this bill is to require full and fair disclosure for the benefit of stockholders while at the same time providing the offeror and management equal opportunity to fairly present their case"); see also *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 8 (1985) ("The purpose of the Williams Act is to insure that public shareholders who are confronted by a cash tender offer for their stock will not be required to respond without adequate information." (quoting *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 58 (1975))); *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 26-35 (1977) (discussing legislative history of Williams Act and concluding that "[t]he legislative history thus shows that the sole purpose of the Williams Act was the protection of investors who are confronted with a tender offer"); *United States v. Chestman*, 903 F.2d 75, 84 (2d Cir. 1990) (stating that Congress delegated Section 14(e) power to SEC to protect investors), *vacated in part en banc*, 947 F.2d 551 (2d Cir. 1991); *Lewis v. McGraw*, 619 F.2d 192, 195 (2d Cir. 1980) (per curiam) (same).

62. See *1967 Senate Hearings*, *supra* note 61, at 205 (statement of Manuel F. Cohen, SEC Chairman) (expressing concern about protection of shareholders); *id.* at 57 (statement of Samuel L. Hayes III, Professor of Finance, Graduate School of Business, Columbia University) (claiming that investors, rather than bidders or defending management, need protection in tender offer situations); 113 CONG. REC. 854, 857-58 (1967) (statement of Sen. Kuchel) (voicing concern about protecting investors and target companies); Lyman Johnson & David Millon, *Misreading the Williams Act*, 87 MICH. L. REV. 1862, 1896-97 (1989) (noting that in Williams Act, Congress established position of "neutrality" toward desirability of tender offers and "sought simply to make sure that target company shareholders would have sufficient disclosure and procedural protection to respond rationally if and when tender offers occurred"). By regulating activities related to tender offers, Congress intended to preserve the integrity of the takeover market by ensuring that investors remained confident that parties with inside information were not manipulating stock prices. See *1968 House Hearings*, *supra* note 3, at 44-45 (statement of Donald L. Calvin, Vice President, New York Stock Exchange) (expressing concern about adverse affects on market due to investors trading on material nonpublic information derived from information leaks and from rumors preceding tender offer announcements); 113 CONG. REC. 24,662, 24,665 (1967) (statement of Sen. Kuchel) (asserting that "passage of S. 510 [Williams Act] will revitalize the strength, vitality, and integrity of our entire securities system").

tion 14(e) in 1970.⁶³ The sponsor of the 1970 amendment to the Williams Act, New Jersey Senator Harrison A. Williams, Jr., argued that Congress should grant the SEC extensive rulemaking authority to provide the agency with the flexibility to address rapidly changing corporate takeover techniques.⁶⁴

Based on these first two sentences, Section 14(e) has three distinct aspects.⁶⁵ First, Section 14(e) prohibits any person from making false or misleading statements.⁶⁶ Second, Section 14(e) prohibits any person from engaging in "fraudulent, deceptive or manipulative acts or practices."⁶⁷ Third, Section 14(e) authorizes the SEC to "define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive or manipulative."⁶⁸ As a product of the SEC's Section 14(e) power, Rule 14e-3 establishes a "disclose-or-abstain" requirement by mandating that any person with material, nonpublic information regarding an impending tender offer either disclose the information publicly or abstain from trading in the stock of corporations involved in the offer.⁶⁹

In *Schreiber v. Burlington Northern, Inc.*,⁷⁰ the Supreme Court stated that Section 14(e) added a "broad antifraud prohibition," modeled on the antifraud provisions of § 10(b) of the Act and Rule 10b-5.⁷¹ The timing of the SEC

63. See Act of December 22, 1970, Pub. L. No. 91-567, sec. 5, § 14(e), 84 Stat. 1497, 1497-98 (codified at 15 U.S.C. § 78n(e) (1994)) (providing amendment to Section 14(e)); see also *United States v. Chestman*, 947 F.2d 551, 557 (2d Cir. 1991) (en banc) (describing history of Section 14(e)).

64. See 116 CONG.REC. 29,251, 29,252 (1970) (statement of Sen. Williams) (arguing that additional rulemaking power in 1970 amendment was necessary for SEC to deal with changing takeover methods and defenses). Senator Williams argued that with increased power, the SEC could adequately protect investors from unfair trading activities by ensuring that all investors had equal access to material information. See *id.* at 29,253 (statement of Sen. Williams) (contending that amendment to Williams Act would guarantee that all investors had equal access to material information regarding tender offers).

65. Mark J. Loewenstein, *Section 14(e) of the Williams Act and the Rule 10b-5 Comparisons*, 71 GEO. L.J. 1311, 1330-31 (1983) (describing three aspects of Section 14(e)); see also 15 U.S.C. § 78n(e) (1994) (providing text of Section 14(e)).

66. 15 U.S.C. § 78n(e) (1994); Loewenstein, *supra* note 65, at 1330.

67. 15 U.S.C. § 78n(e) (1994); Loewenstein, *supra* note 65, at 1330.

68. 15 U.S.C. § 78n(e) (1994); Loewenstein, *supra* note 65, at 1330-31.

69. See 17 C.F.R. § 240.14e-3(a) (1997) (providing text of Rule 14e-3); see also *SEC v. Maio*, 51 F.3d 623, 635 (7th Cir. 1995) (describing duty under Rule 14e-3 for those in possession of material nonpublic information to either disclose information or abstain from trading in implicated stocks regardless of existence of fiduciary duty); *United States v. Chestman*, 947 F.2d 551, 557 (2d Cir. 1991) (en banc) (same); Allen, *supra* note 3, at 1055 (same).

70. 472 U.S. 1 (1985).

71. *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 10 (1985) (quoting *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 24 (1977)). In December 1982, Burlington Northern, Inc. (Burlington) proposed, through a hostile tender offer, to purchase 25.1 million El Paso Gas Co. (El Paso)

action, coupled with the similarities in language and legislative intent, have led some courts and commentators to draw parallels between Rule 10b-5 and Rule 14e-3.⁷² Arguably, the close connection between the two provisions enables courts properly to draw on precedent interpreting Section 10(b) and Rule 10b-5 when faced with Section 14(e) and Rule 14e-3 issues.⁷³

Nevertheless, reasons exist to maintain a separation between the Sections and corresponding Rules. First, the two rules are subject to different interpretations because the SEC intended for them to address different securities fraud situations.⁷⁴ Additionally, the congressional intent underlying Section 14(e)

shares at \$24 per share. *Id.* at 2-3. Initially, El Paso management opposed the takeover, but its shareholders chose to subscribe to the offer. *Id.* at 3. In January 1983, however, Burlington decided not to accept the tendered shares and instead announced a "new and friendly takeover agreement." *Id.* The new agreement contained provisions that rescinded the previous tender offer, called for the purchase of 4,166,667 shares at \$24 per share, substituted a tender offer for only 21 million shares at \$24 per share, provided protection against a "squeeze-out merger," and approved "golden parachute" contracts for four senior El Paso officers. *Id.* at 3-4. Burlington completed the takeover as El Paso shareholders tendered more than 40 million shares in response to Burlington's new offer. *Id.* at 4. Because of this oversubscription, shareholders who retendered after the retraction of the first offer received substantial proration to which they would not have been subjected under the first offer. *Id.* at 4. Barbara Schreiber, a shareholder, filed suit alleging that Burlington, El Paso, and members of El Paso's board of directors violated Section 14(e) of the Act by engaging in "fraudulent, deceptive, or manipulative acts or practices . . . in connection with any tender offer." *Id.* (quoting 15 U.S.C. § 78n(e) (1994)). Schreiber claimed that Burlington's retraction of its original tender offer, its submission of a replacement offer, and its failure to disclose the "golden parachute" contract agreements manipulated the market for El Paso stock. *Id.* The district court dismissed the suit because it found that "the alleged manipulation did not involve a misrepresentation, and so did not violate § 14(e)." *Id.* After addressing the legislative history and congressional intent behind Section 14(e), the Supreme Court affirmed the lower court's decision, finding that manipulation under Section 14(e) requires misrepresentation or nondisclosure and "[w]ithout misrepresentation or nondisclosure, § 14(e) has not been violated." *Id.* at 12 (citing 15 U.S.C. § 78n(e) (1994)).

72. See *United States v. Chestman*, 903 F.2d 75, 85 (2d Cir. 1990) ("As a general matter, principles developed under rule 10b-5 are applicable in determining whether section 14(e) violations have been committed."), *vacated in part en banc*, 947 F.2d 551 (2d Cir. 1991); *Connecticut Nat'l Bank v. Fluor Corp.*, 808 F.2d 957, 961 (2d Cir. 1987) (finding that Section 14(e) and Rule 10b-5 prohibit similar activity (citing *Chris-Craft Indus. v. Piper Aircraft Corp.*, 480 F.2d 341, 362 (2d Cir. 1973))); Hill, *supra* note 11, at 544 (discussing parallels in language of Section 14(e) and Rule 10b-5); Martin, *supra* note 11, at 674 (stating that purpose of Section 10(b) is to prohibit "manipulation or deception in connection with the purchase or sale of securities" while the purpose of Section 14(e) is to prohibit "manipulation or deception or fraud in connection with a tender offer").

73. See *United States v. O'Hagan*, 92 F.3d 612, 625-27 (8th Cir. 1996) (looking to *Schreiber* and *Chiarella* as authority for interpreting language of Section 14(e) and Rule 14e-3), *rev'd*, 117 S. Ct. 2199 (1997); *Chestman*, 947 F.2d at 585-87 (Mahoney, J., dissenting) (same).

74. See *Chestman*, 947 F.2d at 560 (stating that "Section 10(b) is a general antifraud statute, while Section 14(e) is an antifraud provision specifically tailored to the field of tender offers, an

is clear, but the legislative history of Section 10(b) is somewhat ambiguous.⁷⁵ Furthermore, Congress may have modeled Section 14(e) on Section 15(c)(2)⁷⁶ of the Act, rather than after Section 10(b).⁷⁷ Finally, some courts have found that the SEC resolved to restrict Rule 10b-5 to common-law fraud, but intended Rule 14e-3 to apply to conduct beyond that limitation.⁷⁸ These arguments question the persuasiveness of *Chiarella*⁷⁹ and *Schreiber*⁸⁰ as precedent for challenging the SEC's authority to promulgate Rule 14e-3.

B. Circuit Court Cases Upholding SEC's Promulgation of Rule 14e-3

1. The Second Circuit: *United States v. Chestman*

In *United States v. Chestman*,⁸¹ the Second Circuit, sitting en banc, found that the SEC's promulgation of Rule 14e-3 was within the statutory authority granted in Section 14(e).⁸² A jury in the United States District Court for

area of the securities industry that, the Williams Act makes clear, deserves special regulation.").

75. See *id.* at 561 (citing *Chiarella* for proposition that legislative history offers no guidance for interpreting Section 10(b) while language of Section 14(e) reflects definite delegation of power from Congress to SEC to regulate tender offer fraud); Loewenstein, *supra* note 65, at 1356 (stating that Section 14(e) commands SEC to promulgate rules that define and prevent fraud while Section 10(b) does not include such power to define manipulative or deceptive acts or to prevent fraud).

76. 15 U.S.C. § 78o(c)(2)(D) (1994). In describing the SEC's rulemaking power relating to actions by securities dealers and brokers, Section 15(c)(2) of the Act states:

The Commission shall, for the purposes of this paragraph, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative and such quotations as are fictitious.

Id.

77. See *United States v. Chestman*, 947 F.2d 551, 561 (2d Cir. 1991) (en banc) (asserting that rulemaking provision of Section 14(e) "mirrors" Section 15(c)(2) and not Section 10(b)); H.R. REP. NO. 91-1655, at 4 (1970), reprinted in 1970 U.S.C.C.A.N. 5025, 5028 ("The language of the addition to Section 14(e) is identical to that contained in Section 15(c)(2) of the Securities Exchange Act concerning practices of brokers and dealers in securities transactions in the over-the-counter markets.").

78. See *Chestman*, 947 F.2d at 561-62 (asserting that although nothing in language, SEC discussions, or administrative interpretations of Rule 10b-5 ever alluded to application beyond common law fraud, language of Rule 14e-3 shows SEC intent for application beyond common law meaning); SEC v. Peters, 978 F.2d 1162, 1167 (10th Cir. 1992) (arguing that particular characteristics of tender offer situations necessitated that SEC "ease the evidentiary burden by eliminating the need to prove breach of fiduciary duty" with Rule 14e-3).

79. See *Chestman*, 947 F.2d at 560-62 (describing limits on *Chiarella*'s value as precedent for Section 14(e) analysis).

80. See *id.* at 562-63 (highlighting differences between Section 14(e) and Section 10(b) discussed in *Schreiber*).

81. 947 F.2d 551 (2d Cir. 1991).

82. See *United States v. Chestman*, 947 F.2d 551, 563 (2d Cir. 1991) (en banc) (holding

the Southern District of New York had found Robert Chestman, a stockbroker, guilty of ten counts of violating Rule 14e-3(a), ten counts of violating Rule 10b-5, ten counts of mail fraud, and one count of perjury.⁸³ These charges stemmed from Chestman's trading in Waldbaum, Inc. (Waldbaum) stock immediately before Ira Waldbaum, president and controlling shareholder of Waldbaum, agreed to sell the company to the Great Atlantic and Pacific Tea Company (A&P).⁸⁴

Chestman appealed his convictions, claiming that Rule 14e-3 was invalid because the SEC exceeded its rulemaking authority when it dispensed with one of the common-law elements of fraud in nondisclosure cases — breach of fiduciary duty.⁸⁵ In three separate opinions by Judges Miner,⁸⁶

that Rule 14e-3(a) is within SEC regulatory power). The court based its holding on the plain language of Section 14(e) and congressional intent. *Id.*

83. *Id.* at 556; *see also* United States v. Chestman, 704 F.Supp. 451, 454-58 (S.D.N.Y. 1989) (denying Chestman's motion to dismiss indictments for Rule 14e-3 violations due to SEC's invalid exercise of rulemaking authority in promulgating Rule 14e-3), *rev'd*, 903 F.2d 75 (2d Cir. 1990), *vacated in part en banc*, 947 F.2d 551 (2d Cir. 1991).

84. *See Chestman*, 947 F.2d at 555-56 (summarizing facts of case). On November 21, 1986, Ira Waldbaum agreed to tender a controlling block of Waldbaum stock to A&P at a price of \$50 per share. *Id.* at 555. Waldbaum was a publicly traded company that owned a large supermarket chain. *Id.* On November 23, Ira told his three children; his nephew; and his sister, Shirley Witkin, about the impending sale. *Id.* On November 24, despite a warning from Ira not to discuss the sale with anyone, Shirley told her daughter, Susan Loeb, about the sale of the company. *Id.* The next day, Susan told her husband, Keith Loeb, about the tender offer and admonished him not to tell anyone about the sale. *Id.*

On November 26, in spite of his wife's warnings, Keith contacted Chestman, his stockbroker for the previous four years. *Id.* Chestman was aware that Keith's wife was the granddaughter of Julia Waldbaum, a member of the Waldbaum board of directors, the wife of its founder, and the mother of the company's president. *Id.* Keith spoke with Chestman between 9:00 A.M. and 10:30 A.M. and suggested to him that Ira was prepared to accept a tender offer for Waldbaum stock at a price well above its market value. *Id.* During the course of the morning and early afternoon, Chestman purchased 3000 shares of Waldbaum at \$24.65 for his own account and 8000 shares at prices between \$25.75 and \$26.00 per share for his clients' discretionary accounts, one of which belonged to Keith Loeb. *Id.* Later in the afternoon, Keith called Chestman again, and Chestman told him that Waldbaum was a "buy" stock based on his research. *Id.* Keith then had Chestman purchase 1000 shares on Keith's behalf. *Id.* The tender offer for Waldbaum was publicly announced after the market closed on November 26. *Id.* During the next business day, the price of Waldbaum stock rose to \$49 per share. *Id.*

85. *See* United States v. Chestman, 903 F.2d 75, 77 (2d Cir. 1990) (noting Chestman's argument that "his conviction under rule 14e-3 was improper because the Securities and Exchange Commission (SEC) exceeded its rulemaking authority in promulgating the rule"), *vacated in part en banc*, 947 F.2d 551 (2d Cir. 1991).

86. *See id.* at 76-84 (providing Judge Miner's opinion). In determining that Rule 14e-3 was valid, Judge Miner distinguished the SEC's Section 14(e) rulemaking power from its Section 10(b) authority by noting Congress's explicit intent in Section 14(e) to assure dis-

Mahoney,⁸⁷ and Carman,⁸⁸ a Second Circuit panel reversed Chestman's

closure in tender offer situations. *Id.* at 83. Accordingly, he believed that Chestman's reliance on the Section 10(b) decisions in *Chiarella* and *Schreiber* was misguided. *Id.* (citing *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 11 (1985)). Judge Miner reasoned that Congress's desire to protect tender offer investors validates the "disclose or abstain" rule provision of Rule 14e-3 even in the absence of a fiduciary duty. *Id.* Judge Miner determined that Congress approved the SEC's promulgation of the Rule when it enacted the Insider Trading Sanctions Act of 1984 (ITSA), providing treble damages for Rule 14e-3 violations. *Id.* at 83-84 (citing H.R. REP. NO. 98-355, at 13 n.20 (1983), reprinted in 1984 U.S.C.C.A.N. 2274, 2286 n. 20).

Judge Miner also found that application of Rule 14e-3 to traders who knew or had reason to know that their information was material and derived from an insider was consistent with Section 14(e)'s broad mandate to proscribe means reasonably designed to prevent fraudulent acts. *See id.* at 83-84 (emphasizing SEC's broad power under Section 14(e) and Congress's desire to protect investors).

87. *See id.* 84-86 (Mahoney, J., concurring in part and dissenting in part) (providing Judge Mahoney's opinion). Judge Mahoney looked to the specific language of Section 14(e) and Rule 14e-3 to find that the SEC exceeded its rulemaking authority. *See id.* (Mahoney, J., dissenting) (analyzing language of Section 14(e) to determine if Rule 14e-3 falls within scope of SEC's power). Judge Mahoney determined that the language did not permit the SEC to redefine the meaning of fraud, deceit, or manipulation in a manner inconsistent with Supreme Court rulings concerning Section 10(b) and Rule 10b-5. *Id.* 85-86 (Mahoney, J., dissenting). He found that the court should apply Rule 10b-5 principles, such as those found in *Chiarella*, to its interpretation of Section 14(e)'s delegation of power. *Id.* at 85 (Mahoney, J., dissenting) (citing *Connecticut Nat'l Bank v. Fluor Corp.*, 808 F.2d 957, 961 (2d Cir. 1987)). In addressing the language of Section 14(e), Judge Mahoney determined that the statute "authorizes the Commission to prescribe rules which will 'define . . . such acts and practices as are fraudulent, deceptive or manipulative' in the tender offer context" but does not authorize "the Commission to redefine the meaning of the terms 'fraudulent, deceptive or manipulative' as established by authoritative Supreme Court interpretations of section 10(b) and rule 10b-5, upon which section 14(e) is concededly modeled." *Id.* at 85-86 (Mahoney, J., dissenting) (citing *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 104 n.10 (1985)). Finally, he discounted Judge Miner's contention that Congress approved the promulgation of Rule 14e-3 in its discussion of ITSA, arguing instead that congressional references to the Rule were casual, that they explicitly refused to discuss the substantive law of trading, and that they did not amount to an approval of the SEC's rulemaking. *Id.* at 86 (Mahoney, J., dissenting).

88. *See id.* at 86-88 (Carman, J., concurring) (providing Judge Carman's opinion). Judge Carman reasoned that Rule 14e-3 was valid as long as any conviction for nondisclosure under the Rule was contingent upon a showing of the elements of fraud: scienter and breach of duty. *Id.* at 86-87 (Carman, J., concurring). He asserted that "there should be no conviction of a crime under rule 14e-3 unless there has been separate substantive proof of fraudulent, deceptive, or manipulative acts." *Id.* at 86 (Carman, J., concurring). He argued that Congress did not grant the SEC the power to redefine fraud; therefore, the courts must apply the accepted principles and elements of fraud to Rule 14e-3 cases. *Id.* at 87 (Carman, J., concurring). Breach of duty is an element of fraud in nondisclosure cases. *Id.* at 88 (Carman, J., concurring) (citing *United States v. Chiarella*, 445 U.S. 222, 228 (1980)).

If a Rule 14e-3 violation did not require a showing of the elements of fraud, Judge Carman agreed with Judge Mahoney that the SEC exceeded its authority when it promulgated the Rule. *Id.* at 87 (Carman, J., concurring). Judge Carman stated that if a Rule 14e-3 violation

Rule 14e-3 convictions, as well as his convictions for the Rule 10b-5 violations, mail fraud, and perjury.⁸⁹ In so doing, a division arose on the Second Circuit panel as to the validity of Rule 14e-3, but a majority determined that a breach of duty was necessary for a nondisclosure violation.⁹⁰

Sitting en banc, the Second Circuit vacated the panel's decision and affirmed Chestman's Rule 14e-3 convictions.⁹¹ Writing an opinion joined by four other judges, Judge Meskill determined that the SEC's promulgation of Rule 14e-3 was well within the broad delegation of power that Congress granted the agency in Section 14(e).⁹² He reasoned that the language of Section 14(e) affords the SEC the power to define fraud for tender offer situations.⁹³ Judge Meskill found that if the court limited the SEC to the common-law definition of fraud, then the delegation of rulemaking power in Section 14(e) would be a "hollow gesture."⁹⁴ In addition, Judge Meskill asserted that Rule 14e-3 was valid under the SEC's Section 14(e) delegation of power to "prescribe means reasonably designed to prevent"⁹⁵ fraud because such authority "necessarily encompasses the power to proscribe conduct outside the purview of fraud, be it common law or SEC-defined fraud."⁹⁶

Furthermore, Judge Meskill determined that the legislative history of Section 14(e) upholds this broad interpretation of the SEC's authority.⁹⁷ He also concluded that congressional silence on the issue and the references to Rule 14e-3 in the legislative histories of the Insider Trading Sanction Act of 1984⁹⁸

could occur without a showing of the elements of fraud, then Judge Mahoney was correct and the Rule is invalid. *Id.* (Carman, J., concurring).

89. *Id.* at 76-77.

90. See *supra* notes 86-88 and accompanying text (discussing Judge Miner's conclusion that Rule 14e-3 was valid as written, Judge Mahoney's opinion that Rule 14e-3 was invalid under authority granted in Section 14(e), and Judge Carman's finding that Rule 14e-3 was valid as long as it required showing of scienter and breach of fiduciary duty).

91. *United States v. Chestman*, 947 F.2d 551, 554 (2d Cir. 1991) (en banc).

92. *Id.* at 558-59.

93. See *id.* at 558 ("It is difficult to see how the power to 'define' fraud could mean anything less than the power to 'set forth the meaning of' fraud in the tender offer context." (quoting WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 592 (1971))).

94. *Id.* Judge Meskill warned that "[u]nder Chestman's construction of the statute, the separate grant of rulemaking power would be rendered superfluous because the SEC could never define as fraud anything not already prohibited by the self-operative provision." *Id.*

95. *Id.* (quoting 15 U.S.C. § 78n(e) (1994)).

96. *Id.*

97. See *id.* at 559 (determining that legislative history of Section 14(e) demonstrates Congress's intent to delegate broad rulemaking power to SEC).

98. Insider Trading Sanctions Act of 1984 (ITSA), Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.). In its consideration of the ITSA, the House Committee on Energy and Commerce (House Committee) noted that the SEC promul-

(ITSA) and the Insider Trading and Securities Fraud Act of 1988⁹⁹ (ITSFEA) supported the Rule's validity.¹⁰⁰ Finally, he distinguished *Chiarella* and *Schreiber* as precedents for evaluating Rule 14e-3 cases.¹⁰¹ Judge Winter, also writing for four other judges, concurred with Judge Meskill and affirmed Chestman's Rule 14e-3 convictions by reasoning that a person who received information from a source enumerated in the Rule¹⁰² should know that the source breached a duty by supplying the information.¹⁰³

gated "Rule 14e-3, which prohibits certain persons who learn of an impending, but as yet undisclosed, tender offer from trading while in possession of that information," based on the "broad antifraud remedy under section 14(e), which authorizes the Commission to promulgate rules and regulations to proscribe fraudulent, deceptive and manipulative acts in connection with any tender offer." H.R. REP. NO. 98-355, at 4 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2277. Later in the report, the House Committee discussed its intention for the SEC to use its rulemaking authority under the ITSA to promulgate a rule similar to Rule 14e-3: "Rule 14e-3 recognizes that it is inappropriate to hold a firm responsible in a situation in which an effective process is in place to prevent passage to a firm's trading desk of material nonpublic information known by others in the firm." *Id.* at 11, *reprinted in* 1984 U.S.C.C.A.N. 2274, 2284. Finally, the House Committee cited Rule 14e-3 in a footnote in the report for the proposition that "[r]ecent action by the Commission and the courts has clarified the legal principles governing the smaller number of cases that involve trading on information that originates from sources other than the company – for example, information about a future tender offer." *Id.* at 13 n.20, *reprinted in* 1984 U.S.C.C.A.N. 2274, 2286 n.20.

99. Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C.). In its report on the ITSFEA, the House Committee found that Rule 14e-3 has motivated many firms to implement procedures "to detect insider trading and other market abuses by their employees, and control the flow of information within a firm to prevent the misuse of such information." H.R. REP. NO. 100-910, at 14 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6051.

100. *United States v. Chestman*, 947 F.2d 551, 560 (2d Cir. 1991) (en banc).

101. *Id.* at 560-63. Judge Meskill determined that *Chiarella* lacked value as precedent for interpreting Section 14(e) because: (1) it concerned Section 10(b), not Section 14(e) and (2) the congressional intent underlying Section 14(e) is clear, while the congressional intent behind Section 10(b) is not. *Id.* at 560-61. Judge Meskill also concluded that the *Schreiber* Court's analysis of the similarities and differences between Section 14(e) and Section 10(b) did not support the contention that the scope of Section 14(e) should be the same as that of Section 10(b). *Id.* at 562. Judge Meskill noted that "[t]he [*Schreiber*] Court was not confronted with the question raised here – whether SEC action pursuant to the rulemaking delegation exceeds statutory authority – because the petitioner did not point to any SEC rules drafted under Section 14(e) that covered Burlington's activities." *Id.* at 563. Similarly, he asserted that the plaintiff's definition of "manipulative" in *Schreiber* was inconsistent with the intent of Congress under Section 14(e), while Rule 14e-3 complied with the objectives of Section 14(e). *Id.*

102. See 17 C.F.R. § 240.14e-3(a) (1997) (listing prohibited sources of information for purposes of Rule as "(1) The offering person, (2) The issuer . . . or (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer").

103. See *Chestman*, 947 F.2d at 581 (Winter, J., concurring) (imputing breach of duty responsibility to parties who knowingly receive information from persons who have duty not

Judge Mahoney, however, continued to assert that Rule 14e-3 was invalid.¹⁰⁴ He determined that "the plain meaning of the dispositive language [of Section 14(e)] is that the SEC is empowered to identify and regulate, in this (then) novel context, the 'acts and practices' that fit within the existing legal categories of the 'fraudulent, deceptive or manipulative,' but not to redefine the categories themselves."¹⁰⁵ Furthermore, Judge Mahoney found the other judges' reliance on the legislative history of Section 14(e) and the references to Rule 14e-3 in the ITSA and the ITSFEA congressional hearings unpersuasive because the history and references were inconclusive and offered little substantive support for the validity of Rule 14e-3.¹⁰⁶ Finally, he defended the applicability of *Chiarella* and *Schreiber* as persuasive precedents for interpreting Section 14(e) and for finding that the SEC exceeded its rulemaking authority.¹⁰⁷

2. The Tenth Circuit: SEC v. Peters

In 1992, the Tenth Circuit held in *SEC v. Peters*¹⁰⁸ that Rule 14e-3 is consistent with its enabling statute and true to Congress's intent in enacting Section 14(e).¹⁰⁹ The SEC brought a civil action against Don Peters, a financial

to disclose). Judge Winter reasoned that although Rule 14e-3 does not require a breach of duty specifically, all sources of information mentioned in the Rule have a duty under state law not to reveal nonpublic, material information regarding tender offers. *Id.* (Winter, J., concurring). Thus, "[o]ne who receives such information knowing the source can be held to know of a breach of duty." *Id.* (Winter, J., concurring).

104. *See id.* at 588 (Mahoney, J., dissenting) ("In promulgating rule 14e-3(a), the SEC has once again, in my view, acted in excess of its statutory authority.").

105. *Id.* at 584 (Mahoney, J., dissenting) (quoting 15 U.S.C. § 78n(e) (1994)). Judge Mahoney stated that the court should apply the accepted legal definition of the term "fraud" to Section 14(e) rather than allowing the SEC to redefine fraud. *Id.* (Mahoney, J., dissenting).

106. *Id.* at 584-85 (Mahoney, J., dissenting). Judge Mahoney also found that the cases cited by the majority in support of Rule 14e-3 were easily distinguished from *Chestman*. *Id.* at 585-86 (Mahoney, J., dissenting).

107. *Id.* at 586-87 (Mahoney, J., dissenting). Judge Mahoney believed that *Chiarella's* discussion of common law fraud was a persuasive precedent in analyzing Section 14(e) because Section 10(b) and Section 14(e) were related. *Id.* (Mahoney, J., dissenting). He discounted the importance of the differences in language between Section 14(e) and Section 10(b). *Id.* at 587 (Mahoney, J., dissenting). Likewise, he found the *Chiarella* Court's failure to disapprove of the application of the then-proposed Rule 14e-3 to warehousing of target stock to be inconclusive because "[s]uch a disapproval would have been wholly gratuitous in the circumstances." *Id.* (Mahoney, J., dissenting). Similarly, he found *Schreiber* persuasive due to its assertion that Section 14(e) was modeled after Section 10(b) and its rejection of the argument that Section 14(e) allows the SEC to change the definition of "manipulative." *Id.* (Mahoney, J., dissenting).

108. 978 F.2d 1162 (10th Cir. 1992).

109. *See SEC v. Peters*, 978 F.2d 1162, 1165 (10th Cir. 1992) (holding that Rule 14e-3 is

planner, for insider trading in violation of Section 10(b), Rule 10b-5, and Rule 14e-3.¹¹⁰ At trial in the U.S. District Court for the District of Kansas, a jury found for Peters on each complaint asserted in the SEC's suit.¹¹¹ On appeal, the SEC argued that the court incorrectly instructed the jury that in order to find Peters liable for violating Rule 14e-3, it must find that "the defendant's action . . . constituted a violation of the relationship of trust and confidence" that he held with his partner.¹¹² The SEC maintained that liability for a nondisclosure violation of Rule 14e-3 does not require a breach of a fiduciary duty and that the trial court's jury instruction to the contrary was in error.¹¹³

Judge Ebel, writing for the court, sought to determine what Congress intended by its use of "fraudulent, deceptive, or manipulative" in drafting Section 14(e) and what limits this language placed on the SEC's rulemaking power.¹¹⁴ Judge Ebel, citing Judge Meskill's opinion in *Chestman*, opined that the SEC "reasonably designed" Rule 14e-3 to achieve the Section 14(e) objective of preventing fraudulent nondisclosure in tender offer situations by "easing the evidentiary burden" while not altering the meanings of the terms "fraudulent," "deceptive," and "manipulative."¹¹⁵ He noted that a significant number of people may have access to confidential information relating to a specific tender offer and some of those people might lack loyalty to the issuer and fail

"consistent with its statutory mandate and with the policy Congress sought to implement"). Don Peters and Ivan West were partners in Investment Management Group (IMG), a financial management firm. *Id.* In addition to his work for IMG, West provided consulting services for Energy Resources Group, Inc. (ERG) that included assisting in ERG's search for an investor willing to make a friendly tender offer for ERG's stock. *Id.* Eventually, West's efforts helped ERG negotiate a deal with Broken Hill Proprietary Company (Broken Hill) in which Broken Hill agreed to make a tender offer for ERG's stock. *Id.*

When Broken Hill made its tender offer for the ERG shares, the SEC identified suspicious trading activities involving the stock. *See id.* (noting SEC investigation of investors who bought large amounts of ERG stock shortly before tender offer announcement and sold stock soon after announcement at large profit). Shortly before the announcement of Broken Hill's tender offer, several private parties purchased ERG stock that they sold at a substantial profit immediately after the public disclosure of the agreement. *Id.* The SEC contended that Peters gave these investors information about the tender offer before it was made public. *Id.* According to the SEC, Peters, without West's knowledge, viewed documents relating to Broken Hill's tender offer that West kept in his office at IMG. *Id.* The SEC alleged that Peters gathered information about the tender offer from the documents and shared it with Ken Mick, a stockbroker, and Bernard Lounsbury, one of Peters's former clients. *Id.* The SEC contended that Mick and Lounsbury used this information to reap substantial gains by trading in ERG stock. *Id.*

110. *Id.* at 1164.

111. *Id.* at 1164-65.

112. *Id.* at 1165 (quoting jury instructions).

113. *Id.*

114. *Id.* at 1166.

115. *Id.* (citing *United States v. Chestman*, 947 F.2d 551, 558 (2d Cir. 1991) (en banc)).

to resist the temptation to profit on that information.¹¹⁶ Thus, it can be difficult to prove that an investor traded on information gathered through a breach of a fiduciary duty even though circumstantial evidence of such an act may be readily available.¹¹⁷ To address this problem, Judge Ebel determined, Congress granted the SEC broad prophylactic power that the SEC used to promulgate Rule 14e-3.¹¹⁸ He found further support for the validity of Rule 14e-3 in Congress's approval of "the rules and regulations of the SEC under the Securities and [sic] Exchange Act of 1934 governing trading while in possession of material nonpublic information"¹¹⁹ in the official findings included in ITSFEA.¹²⁰ Judges Moore and Alley joined Judge Ebel in reversing the trial court's finding for Peters and remanding the case for a new trial.¹²¹

3. *The Seventh Circuit: SEC v. Maio*

In *SEC v. Maio*,¹²² the Seventh Circuit held that Rule 14e-3 is "clearly within the SEC's grant of authority."¹²³ After an extensive bench trial in the

116. *Id.* at 1167.

117. *See id.* (stating that "it may be possible to prove circumstantially that a person was knowingly trading on inside information, but almost impossible to prove that the trader obtained such information in breach of a fiduciary duty owed either by the trader or by the ultimate insider source of the information").

118. *Id.* Judge Ebel believed that Rule 14e-3 is consistent with the SEC's broad Section 14(e) power to proscribe prophylactic measures. *Id.* He determined that the Rule is "reasonably designed" to prevent fraudulent trading on insider information by prohibiting the recipient of such insider information from trading on it when such person knows that the source of the information could not trade on it." *Id.*

119. *See id.* (quoting Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), Pub. L. No. 100-704, § 2, 102 Stat. 4677, 4677 (codified as amended in scattered sections of 15 U.S.C.)). Ebel admitted: "Congress does not appear to have specifically debated Rule 14e-3, but we presume that Congress was aware of Rule 14e-3 and its implications when it made its finding." *Id.*

120. Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA) § 2. In the findings contained in ITSFEA, Congress determined that:

(1) the rules and regulations of the Securities and Exchange Commission under the Securities Exchange Act of 1934 governing trading while in possession of material, nonpublic information are, as required by such Act, necessary and appropriate in the public interest and for the protection of investors;

(2) the Commission has, within the limits of accepted administrative and judicial construction of such rules and regulations, enforced such rules and regulations vigorously, effectively, and fairly. . . .

Id.

121. *SEC v. Peters*, 978 F.2d 1162, 1173 (10th Cir. 1992). Judge Alley concurred in the majority's analysis of the Rule 14e-3 convictions, *see id.* at 1173 (Alley, J., concurring), but dissented on other issues presented in the case involving the exclusion of evidence at trial. *See id.* at 1173-77 (Alley, J., dissenting) (providing Judge Alley's opinion).

122. 51 F.3d 623 (7th Cir. 1995).

123. *SEC v. Maio*, 51 F.3d 623, 635 (7th Cir. 1995). Louis P. Ferrero met Michael Maio

United States District Court for the Southern District of Indiana, the court found that Michael Maio's and Patricia Ladavac's sales of Anacomp, Inc. stock and purchases of Xidex stock violated Section 10(b), Section 14(e), Rule 10b-5, and Rule 14e-3.¹²⁴ On appeal, Ladavac and Maio argued that Rule 14e-3 exceeded the power granted to the SEC in Section 14(e) because

through their mutual friend, Dr. Ronald Palamara. *Id.* at 627. Maio, Ferrero, and Palamara became close friends. *Id.* Palamara was the founder of Anacomp, Inc., a large, publicly held company specializing in information services. *Id.* Based partly on a recommendation by Maio, Palamara chose Ferrero to succeed him as president of Anacomp. *Id.* As president of the company, Ferrero was privy to nonpublic information regarding other companies with which Anacomp interacted. *See id.* (describing example of type of information that Ferrero had access to through his position). Ferrero would share this material nonpublic information with Maio, who used it to invest in the stock market. *Id.*

In February 1988, Xidex, a microfilm manufacturer experiencing a deteriorating financial situation, contacted Anacomp about the possibility of having Anacomp acquire Xidex. *Id.* at 627-28. On June 2, 1988, after Xidex's financial condition had declined further, Xidex President Bert Zaccaria discussed Anacomp's interest in the company with Ferrero and inquired about a possible offering price for the Xidex stock. *Id.* at 628. Ferrero and Zaccaria agreed to meet in Las Vegas on June 6 and 7, 1988, and the two men met at that time as planned to discuss the purchase. *Id.*

Immediately after the meeting, Maio and his close friend, Patricia Ladavac, began to acquire Xidex stock and sell Anacomp stock. *Id.* Such transactions are consistent with knowledge of a tender offer because the stock of the target company in a tender offer usually rises while the price of the offering company's stock drops or remains steady. *See SEC v. Materia*, 745 F.2d 197, 199 (2d Cir. 1984) (stating that usually when tender offer is announced, price of target company rises and price of offeror falls or does not change). Meanwhile, pursuant to the Las Vegas meeting, Anacomp and Xidex took steps to prepare for the purchase. *Maio*, 51 F.3d at 628. On July 7, Ferrero flew to California for a confidential meeting with Xidex regarding the acquisition agreement. *Id.* Immediately prior to and during this trip, Maio and Ladavac made a number of trades in Anacomp and Xidex stock. *Id.* at 628-29. Maio and Ladavac continued to trade in Xidex and Anacomp stock while Ferrero was in Indianapolis attending the Anacomp board meeting at which the board considered the tender offer agreement. *Id.* at 629.

Anacomp and Xidex announced Anacomp's tender offer to the public on July 12. *Id.* Based on the terms of the offer, Xidex's stock rose 26% and Anacomp's fell 13% when the markets opened. *Id.* Immediately after the announcement, Maio and Ladavac sold all of the Xidex stock that they had accumulated. *Id.* In total, Maio purchased 80,000 shares of Xidex for \$527,000 and accumulated profits of \$211,000. *Id.* He also sold 60,000 share of Anacomp and avoided \$66,250 in losses. *Id.* Similarly, Ladavac bought 25,000 shares of Xidex for \$155,000 and accumulated profits of \$78,750, while selling 16,000 shares of Anacomp to avoid losses of \$15,750. *Id.*

At trial, Maio and Ladavac claimed that they traded based on information available to the public. *Id.* The district court rejected this argument and found that Maio and Ladavac violated Section 10(b), Section 14(e), Rule 10b-5, and Rule 14e-3. *Id.* at 629-30. The court also found that Maio and Ladavac's purchase of Anacomp stock violated Section 17(a) of the Act. *Id.* at 630. Ferrero reached an agreement with the SEC in which he consented to an entry of judgment against himself without admitting or denying the SEC's allegations and agreed to pay a penalty exceeding \$275,000. *Id.* at 629.

124. *Id.* at 629-30.

it "created a duty to disclose material non-public information absent a fiduciary duty between the parties to the transaction."¹²⁵ Ladavac and Maio cited *Dirks*, *Chiarella*, and *Schreiber* for the proposition that nondisclosure violates the Act only if a fiduciary relationship between the parties to a transaction creates a duty to disclose.¹²⁶ The SEC responded by claiming that Rule 14e-3 was valid because Section 14(e) grants the SEC the power to define fraud, deceit, and manipulation, as well as to promulgate rules intended to prevent fraudulent, manipulative, or deceptive acts.¹²⁷

Judge Manion, writing for a unanimous panel, rejected Maio's and Ladavac's argument.¹²⁸ He stated: "The power to define and prescribe means 'reasonably designed to prevent' fraudulent, deceptive, or manipulative, acts, and practices must extend further than the mere proscription of acts and practices that are in fact fraudulent, deceptive, or manipulative; otherwise this language is superfluous."¹²⁹ Thus, the SEC has authority to regulate activities that are not themselves fraudulent, deceptive, or manipulative in an effort to prevent the occurrence of acts which do fit into one of those categories.¹³⁰ Based on this reasoning, the panel affirmed the validity of Rule 14e-3 as a legitimate exercise of SEC rulemaking power and upheld the convictions of Maio and Ladavac for Rule 14e-3 violations.¹³¹

C. Eighth Circuit Breaks Ranks: *United States v. O'Hagan*¹³²

In *United States v. O'Hagan*, the Eighth Circuit rejected the courts of appeals decisions in *Chestman*, *Peters*, and *Maio* and held that "the SEC exceeded its rulemaking authority by enacting Rule 14e-3(a) without including a breach of a fiduciary duty."¹³³ Following an SEC investigation into his

125. *Id.* at 635.

126. *Id.*

127. *Id.* (quoting 15 U.S.C. § 78n(e) (1997)).

128. *Id.*

129. *Id.* (citing *SEC v. Peters*, 978 F.2d 1162, 1166 (10th Cir. 1992); *United States v. Chestman*, 947 F.2d 551, 558 (2d Cir. 1991) (en banc)). Judge Manion found persuasive the *Peters* and *Chestman* reasoning upholding the validity of Rule 14e-3 as a permissible exercise of SEC rulemaking power and did not find it necessary to reiterate that reasoning in the court's opinion. *Id.* at 635 n.14.

130. *Id.* at 635.

131. *Id.*

132. *Cf. Leuba*, *supra* note 42, at 1147 (describing as "breaking rank" Fourth Circuit's rejection of application of misappropriation theory to Section 10(b) and Rule 10b-5, despite acceptance of theory by Second, Seventh, and Ninth Circuits).

133. *United States v. O'Hagan*, 92 F.3d 612, 624 (8th Cir. 1996) (noting explicitly split in circuits), *rev'd*, 117 S. Ct. 2199 (1997).

investments in the Pillsbury Company (Pillsbury),¹³⁴ a grand jury indicted James O'Hagan, a lawyer, on twenty counts of mail fraud, three counts of money laundering, seventeen counts of Section 10(b) and Rule 10b-5 violations, and seventeen counts of Section 14(e) and Rule 14e-3 violations.¹³⁵ At trial in the U.S. District Court for the District of Minnesota, a jury found O'Hagan guilty on all fifty-seven counts.¹³⁶ On appeal, O'Hagan argued that the SEC exceeded its rulemaking authority by redefining fraud in its promulgation of Rule 14e-3.¹³⁷

134. *Id.* at 614. Grand Metropolitan PLC (Grand Met) was a large diversified company based in London, England, with an interest in purchasing the Minneapolis-based Pillsbury Company (Pillsbury). *Id.* In July 1988, Grand Met hired the law firm of Dorsey & Witney in Minneapolis to act as local counsel for its acquisition of Pillsbury. *Id.* O'Hagan was a partner at Dorsey & Witney. *Id.* After retaining Dorsey & Witney, Grand Met worked throughout the summer and early fall of 1988 to amass the capital necessary to buy Pillsbury. *Id.*

On August 18, 1988, O'Hagan purchased one hundred Pillsbury call options, all expiring on September 17. *Id.* at 614 n.1. During the remainder of August and September, O'Hagan purchased 2900 more Pillsbury call options with expiration dates of September 17, October 22, and November 19. *See id.* at 614 & n.2 (outlining O'Hagan's call option purchases). At the end of September, O'Hagan held 2500 Pillsbury call options, as well as 5000 shares of Pillsbury common stock that he had purchased on September 10. *Id.* at 614.

On October 4, 1988, Grand Met announced to the public its tender offer for Pillsbury stock. *Id.* Like most stock prices after the announcement of a tender offer, Pillsbury's stock price rose from \$39 per share to almost \$60 per share. *Id.* Shortly after the announcement, O'Hagan sold his call options on the Pillsbury stock and bought the shares at the lower option price. *Id.* Likewise, he sold the 5000 shares of Pillsbury common stock that he bought prior to the announcement. *Id.* In total, O'Hagan reaped profits of over \$4,000,000 on these transactions. *Id.*

135. *Id.* As a partner at Dorsey & Witney, O'Hagan owed a fiduciary duty to Grand Met because Grand Met was the firm's client. *See Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983) (citing lawyer as example of outsider becoming fiduciary of shareholders of corporation due to fact that lawyer "entered into a special confidential relationship in the conduct of the business of the enterprise and [was] given access to information solely for corporate purposes"). Thus, if O'Hagan had traded in Grand Met stock, he would have perpetrated classical insider trading. *See Leuba, supra* note 42, at 1145-46 (describing classical insider trading violation as situation in which corporate insider "obtains material confidential information because of her position and then trades in the shares of the company without disclosing the information" because, in so doing, she "breache[s] the fiduciary obligation owed to the shareholders"). However, O'Hagan traded in Pillsbury stock and not Grand Met stock. *See supra* note 134 (outlining O'Hagan's trades). Because he did not owe a duty to Pillsbury, O'Hagan's failure to disclose the material nonpublic information was not actionable under classical insider trading theory. *See Leuba, supra* note 42, at 1145-46 (describing classical insider trading as requiring breach of duty). Thus, the Government turned to Rule 14e-3 and the misappropriation theory of Rule 10b-5 to prosecute O'Hagan. *O'Hagan*, 92 F.3d at 615.

136. *O'Hagan*, 92 F.3d at 614.

137. *Id.* at 623-24. Summarizing O'Hagan's argument, the court stated that he "claims that the SEC impermissibly redefined fraud in Rule 14e-3(a) by omitting the requirement that a breach of a fiduciary duty must be shown because the term fraud under § 14(e) requires a

The Eighth Circuit agreed with O'Hagan.¹³⁸ Addressing the language of the second sentence of Section 14(e), Judge Hansen, writing for the court, determined that "the statute empowers the SEC to 'define' and 'prescribe means reasonably designed to prevent' 'acts and practices' which are 'fraudulent.'"¹³⁹ According to Judge Hansen, this language grants the SEC power to identify acts that are fraudulent, but it does not give the SEC authority to redefine the term "fraudulent."¹⁴⁰ He rejected the Government's argument that, because Section 14(e) is a broad delegation of power, the court should interpret its language as providing the SEC with the authority to define fraud.¹⁴¹ Rather, he looked to the Supreme Court's holdings in *Chiarella* and *Schreiber* to determine the applicable meaning of fraud.¹⁴² Judge Hansen found that the *Schreiber* Court's reliance on Section 10(b)'s application of the term "manipulation" in a Section 14(e) case supported the proposition that Section 10(b)'s definition of "fraud" should similarly apply to Section 14(e).¹⁴³ Thus, Judge Hansen looked to the *Chiarella* Court's reliance on common-law principles – specifically, that fraudulent nondisclosure in Section 10(b) cannot exist absent a duty to speak – to determine the scope of Section 14(e).¹⁴⁴ He reasoned that "[r]eading *Schreiber* and *Chiarella* together leads to the conclusion that 'fraudulent' under § 14(e) includes a breach of a fiduciary obligation."¹⁴⁵

breach of a fiduciary duty." *Id.*

138. *See id.* at 627 (holding that SEC exceeded its rulemaking authority and vacating O'Hagan's convictions).

139. *Id.* at 624 (quoting 15 U.S.C. § 78n(e) (1994)). Judge Hansen came to this interpretation by "eliminating those words [in the second sentence of Section 14(e)] that have no bearing to our inquiry." *Id.*

140. *Id.* (citing *United States v. Chestman*, 947 F.2d 551, 584 (2d Cir. 1991) (en banc) (Mahoney, J., dissenting)). Judge Hansen asserted that "the enabling provisions simply permit the SEC to 'define' and 'prescribe' 'acts and practices' which meet § 14(e)'s meaning of 'fraudulent.'" *Id.* at 624-25.

141. *Id.* at 624-26. Judge Hansen rejected the Government's argument that if the SEC is unable to define fraud in Section 14(e), then the SEC lacks any substantial power under the statute. *Id.* at 626. He observed that the SEC's ability to define acts and practices in the tender offer context that satisfy the definition of fraudulent "remains a very powerful tool." *Id.* Likewise, he asserted that the "discrepancies in language" and differences in "legislative draftsmanship" between Section 10(b) and Section 14(e) were inconsequential. *Id.* at 626.

142. *Id.* at 625-26. To determine the applicable definition of "fraud," Judge Hansen first turned to *Black's Law Dictionary* for guidance. *Id.* at 625. However, the definition in *Black's* proved inconclusive because it gave some meanings that were consistent with the need for a breach of a fiduciary duty and some that did not include such a requirement. *Id.* (citing BLACK'S LAW DICTIONARY 660 (6th ed. 1990)).

143. *Id.* (citing *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 7-8 & n.6 (1985)).

144. *Id.*

145. *Id.*

Likewise, Judge Hansen refuted the government's contention that "the SEC may regulate conduct which is not fraudulent in order to prevent the commission of a fraudulent act" by noting that such an usurpation of power would disregard Congress's specific use of the word "fraud" in Section 14(e).¹⁴⁶ Judge Hansen addressed the issue of the deference usually given to an administrative agency's interpretation of its enabling statute by referring to cases in which courts had found that the SEC exceeded its rulemaking authority.¹⁴⁷ Accordingly, the court vacated O'Hagan's convictions.¹⁴⁸

IV. The Supreme Court's Decision in O'Hagan

A. A Flawed Analysis: The Majority Opinion in O'Hagan

In a seven-to-two decision,¹⁴⁹ the Supreme Court reversed the Eighth Circuit and affirmed the validity of Rule 14e-3 as a proper use of the SEC's rulemaking authority.¹⁵⁰ Writing for a majority of the Court, Justice Ginsburg evaluated the Government's argument that its interpretation of Section 14(e) empowers the SEC (1) to define fraudulent acts in the tender offer context, and (2) to establish provisions to prevent fraudulent acts.¹⁵¹ The Court chose

146. See *id.* at 627 (finding that "the SEC has broad regulatory powers in the field of tender offers, but the statutory terms have a fixed meaning which the SEC cannot alter by way of administrative rule"). Judge Hansen cited *Schreiber*, in which that Court reasoned that the SEC has the "latitude to regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts, without suggesting any change in the meaning of the term 'manipulative' itself," for the proposition that the SEC cannot change the meaning of the term "fraud." *Id.* (quoting *Schreiber*, 472 U.S. at 11 n.11).

147. *Id.* (citing *Aaron v. SEC*, 446 U.S. 680, 694 n.11 (1980); *IBT v. Daniel*, 439 U.S. 551, 556 n.20 (1979); *Business Roundtable v. SEC*, 905 F.2d 406, 407 (D.C. Cir. 1990)).

148. *Id.* In dissent, Judge Fagg stated that the court should follow the other three circuit courts and uphold the validity of Rule 14e-3. *Id.* at 628 (Fagg, J., dissenting).

149. *United States v. O'Hagan*, 117 S. Ct. 2199, 2204 (1997). Justice Ginsburg wrote the opinion for the Court in which Justices Stevens, O'Connor, Kennedy, Souter, and Breyer joined. *Id.* at 2204-20. Justice Scalia filed an opinion that dissented with the Court's ruling as to Section 10(b) and Rule 10b-5, but concurred in the Court's findings as to Section 14(e) and Rule 14e-3. *Id.* at 2220 (Scalia, J., concurring in part and dissenting in part). Justice Thomas filed an opinion, which Chief Justice Rehnquist joined, that dissented with the Court's findings with regard to Rule 10b-5 and Rule 14e-3. *Id.* at 2220-31 (Thomas, J., concurring in judgment in part and dissenting in part).

150. See *id.* at 2206 (finding that Rule 14e-3 falls under prophylactic power of Section 14(e)).

151. See *id.* at 2216 (summarizing Government's response to Eighth Circuit's interpretation of Section 14(e)). The Government argued that the SEC's defining power would be a virtual nullity if the SEC could not regulate beyond common law fraud. *Id.* The Government also contended that Rule 14e-3 is an application of the SEC's prophylactic power that Section 14(e) provides. See *id.* at 2217 (analyzing prophylactic power of Section 14(e)).

not to address whether the SEC has the authority to redefine fraud and opted instead to uphold Rule 14e-3 as a valid application of the SEC's prophylactic power.¹⁵² In so doing, the Court determined that the scope of a prophylactic rule, by its nature, usually expands beyond the act that the designers of the rule intended to prevent.¹⁵³ The Court held "that under § 14(e), the [SEC] may prohibit acts, not themselves fraudulent under the common law or § 10(b), if the prohibition is 'reasonably designed to prevent . . . acts and practices [that] are fraudulent.'"¹⁵⁴

The Court then analyzed whether the "disclose-or-abstain" provision in Rule 14e-3 is reasonably designed to prevent fraudulent activities.¹⁵⁵ After noting the substantial deference that courts afford to an agency's interpretation of its enabling statute,¹⁵⁶ the Court evaluated whether the SEC's promulgation of Rule 14e-3 was arbitrary or capricious and thus invalid.¹⁵⁷ The Court looked to the SEC's justifications for Rule 14e-3 – the elimination of unfair disparities in information among market participants and the difficulty of proving a breach of duty in tender offer fraud cases – to find that the SEC's promulgation of Rule 14e-3 was not arbitrary or capricious.¹⁵⁸ Thus, the Court determined that the "disclose-or-abstain" requirement in Rule 14e-3 "is a means reasonably designed to prevent" fraudulent trading on material, nonpublic

152. *See id.* (finding that Rule 14e-3 "qualifies under § 14(e) as a 'means reasonably designed to prevent' fraudulent trading on material, nonpublic information in the tender offer context").

153. *See id.* ("A prophylactic measure, because its mission is to prevent, typically encompasses more than the core activity prohibited.").

154. *Id.* (quoting 15 U.S.C. § 78n(e) (1994)).

155. *Id.* at 2217-19.

156. *See id.* at 2217 (stating that SEC's judgment is due "more than mere deference or weight" (quoting *Batterton v. Francis*, 432 U.S. 416, 424-26 (1977))).

157. *See id.* at 2217-18 (finding that Court must grant SEC's interpretation "controlling weight unless [it is] arbitrary, capricious, or manifestly contrary to the statute" (quoting *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984))).

158. *See id.* at 2218 (deciding that SEC's assessment of Section 14(e) is not arbitrary, capricious, or contrary to the statute). The Court analyzed the SEC's justification of Rule 14e-3 "as a means necessary and proper to assure the efficacy of Williams Act protections." *Id.* Those protections, according to the SEC, were aimed at ensuring an equality of information, in that individuals with nonpublic, material information would not be disrupting the market. *Id.* (quoting SEC Rule 14e-3, 45 Fed. Reg. 60,410, 60,412 (1980) (preamble to Rule)). Likewise, the Court evaluated the SEC's asserted purpose in promulgating Rule 14e-3 to address the SEC's difficulty in proving a breach of a fiduciary duty with regard to securities fraud in the tender offer context. *Id.* at 2219. Citing *Peters* for its discussion of the unique problems arising in proving a breach of a fiduciary duty in situations in which a person trades based on material, nonpublic information in the tender offer realm, the Court found the "disclose or abstain" requirement of Rule 14e-3 to be a reasonable means of addressing those problems. *Id.* at 2218-19 (citing *United States v. Peters*, 978 F.2d 1162, 1167 (10th Cir. 1992)).

information in the tender offer context,¹⁵⁹ and therefore is not in excess of the prophylactic power that Congress granted to the SEC in Section 14(e).¹⁶⁰

B. Consideration of Post Hoc Rationalization: The Court's "New Test" for Addressing the Validity of Agency Action

The majority ignored a fundamental principle of administrative law when it declined to address the SEC's stated rationale for promulgating Rule 14e-3 and instead upheld the Rule on the basis of a post hoc justification.¹⁶¹ In reviewing agency action for compliance with its enabling statute, the Supreme Court traditionally has concluded that courts must evaluate the action on the basis the agency supplied and not on rationalizations from counsel or the court itself.¹⁶² On its face, Rule 14e-3 professes to be a product of the SEC's asserted power to redefine fraud for application in the tender offer context.¹⁶³ Rule 14e-3 clearly outlines what "shall constitute a fraudulent, deceptive, or manipulative act within the meaning of § 14(e)."¹⁶⁴ Yet, the majority failed to address this justification and looked to the SEC's prophylactic argument for validation of the rulemaking.¹⁶⁵ The Supreme Court never should have addressed the SEC's claim that Rule 14e-3 was an assertion of its prophylactic power because that was not the SEC's actual justification for its actions.¹⁶⁶ The Court should have looked only at the Government's defining power argument rather than allow the SEC to proffer post hoc grounds for the Rule.¹⁶⁷

159. *Id.* at 2219.

160. *See id.* (ruling that Rule 14e-3 is valid exercise of SEC's power under § 14(e)).

161. *See id.* at 2228 (Thomas, J., dissenting) ("We evaluate regulations not based on the myriad of explanations that could have been given by the relevant agency, but on those explanations and justifications that were, in fact, given.").

162. *See* *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43, 50 (1983) (finding that Court must look to rationale that agency itself provided for action and not justifications that reviewing court or appellate counsel proposed).

163. *See* *United States v. O'Hagan*, 117 S. Ct. 2199, 2228 (1997) (Thomas, J., dissenting) (stating that language of Rule purposes it to be exercise of definitional authority).

164. *See id.* (Thomas, J., dissenting) (asserting, on basis of its language, that Rule is "redefinition of what 'constitute[s] a fraudulent, deceptive, or manipulative act or practice within the meaning of § 14(e)'" (quoting 17 C.F.R. § 240.14e-3(a) (1997))).

165. *See id.* at 2216 (deciding not to address SEC's defining power argument in favor of prophylactic justification).

166. *See id.* at 2228 (Thomas, J., dissenting) (stating that "we need give no deference to the Commission's *post hoc* litigating justifications not reflected in the regulation").

167. *See id.* (Thomas, J., dissenting) (finding assertion that Rule 14e-3 is exercise of preventative authority to be nonsensical and contrary to language of Rule); Kurtz & Sleeper, *supra* note 11, at 728 (stating that "the language of Rule 14e-3 does not even purport to regulate

The majority stated that Rule 14e-3 is a product of the SEC's full rulemaking authority;¹⁶⁸ thus, it "may be conceived and defended, alternatively, as definitional or preventative."¹⁶⁹ The fact that the Rule "may" be an exertion of either power is irrelevant because the Court must only look to the ground that the SEC itself provided for the action.¹⁷⁰ By basing its decision on a justification that the agency did not supply, the Court has altered the accepted test for review of agency action.¹⁷¹ Instead, the Court applied a "new test" in which an agency may provide alternate justifications for its actions after the fact in an effort to rehabilitate its claim that it acted properly.¹⁷² Under the *O'Hagan* reasoning, a reviewing court may use any grounds it wishes to validate agency action.

C. The Court's Misapplication of Its "New Test" in *O'Hagan*

Not only is the Court's "new test" in *O'Hagan* flawed, the Court's application of the "new test" is also problematic.¹⁷³ In evaluating the SEC's

nondeceptive conduct").

168. See *O'Hagan*, 117 S. Ct. at 2218 n.19 ("Sensibly read, the rule is an exercise of the Commission's full authority.").

169. *Id.*

170. See *SEC v. Chenery*, 318 U.S. 80, 87-88 (1943) (confining review to basis that agency supplied for its action); see also RICHARD J. PIERCE, JR. ET AL., *ADMINISTRATIVE LAW AND PROCESS* 336 (2d ed. 1992) ("A court can review an agency action only on the basis of the grounds stated by the agency. If those grounds are inadequate or improper, . . . the court must reverse the agency action even if the action could be affirmed on a basis not stated by the agency.").

171. See *United States v. O'Hagan*, 117 S. Ct. 2199, 2223 (1997) (Thomas, J., dissenting) ("It is a fundamental proposition of law that this Court 'may not supply a reasoned basis for the agency's action that the agency itself has not given.'" (quoting *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43, 50 (1983))).

172. See *id.* (Thomas, J., dissenting) (stating that Court does not give credit to post hoc rationalizations from agencies (quoting *State Farm*, 463 U.S. at 50)).

173. See *id.* at 2228 (Thomas, J., dissenting) (rejecting SEC's prophylactic argument on its merits). On a separate point, Justice Thomas rejected Rule 14e-3 because it applies the SEC's faulty construction of the requirement that the fraudulent acts which the prophylactic measures attempt to prevent must be "in connection with" a tender offer. See *id.* at 2228-29 (Thomas, J., dissenting) (asserting that "misappropriation theory does not represent a coherent interpretation of the statutory 'in connection with' requirement" (quoting 15 U.S.C. § 78n(e) (1994))). Noting inconsistencies and lack of predictability in the Government's interpretation of "in connection with" as it applies to Rule 10b-5 and Section 10(b), Justice Thomas found that interpretation equally problematic with regard to tender offers. *Id.* (Thomas, J., dissenting). Justice Thomas stated that "the Commission has provided no coherent or consistent explanation as to why [the fraud that the SEC's misappropriation theory proscribes] is 'in connection with' a tender offer, and thus the Commission may not seek to prevent indirectly conduct which it could not, under its current theory, prohibit directly." *Id.* at 2229 (Thomas, J., dissenting).

post hoc, preventive power grounds, the Court found that the SEC's broad Section 14(e) authority to enact prophylactic measures to prevent fraudulent acts necessarily encompasses the power to "prohibit acts, not themselves fraudulent under the common law of § 10(b), if the prohibition is 'reasonably designed' to prevent" fraud.¹⁷⁴ The Court determined that the SEC may implement a disclose-or-abstain rule for tender offer nondisclosure situations under the auspice of preventing fraudulent acts even though such regulated activities are not themselves fraudulent.¹⁷⁵ The regulation of these non-fraudulent acts, however, must be reasonably designed to prevent acts that are fraudulent.¹⁷⁶

The SEC provided two rationales for eliminating the breach of fiduciary duty requirement: the difficulty of proving a breach of duty and the integrity of the markets.¹⁷⁷ With regard to the difficulty in proving a breach of duty in these tender offer fraud cases, such concern is unjustified given the majority's affirmation of the misappropriation theory.¹⁷⁸ In misappropriation cases, Rule 14e-3 requires that the defendant "know or have reason to know" that the bidder or an agent of the bidder was the source of his nonpublic, material information.¹⁷⁹ The SEC's assertion fails because, upon determining the source of the defendant's information, the SEC would have little trouble proving that the source breached a duty.¹⁸⁰

174. *Id.* at 2217 (holding that Section 14(e) encompasses broad prophylactic power). *But see* Kurtz & Sleeper, *supra* note 11, at 728 (stating that "Rule 14e-3 cannot be justified on the basis of the SEC's power to regulate *nondeceptive* conduct").

175. *See O'Hagan*, 117 S. Ct. at 2217 (stating that prophylactic power includes authority beyond prohibition of core activity). Justice Thomas agreed with the majority that the prophylactic measure in Section 14(e) enables the SEC to proscribe acts that are not themselves fraudulent, but are designed to prevent fraudulent acts. *See id.* at 2228 (Thomas, J., dissenting) (determining that "§ 14(e) authorizes the Commission to prohibit non-fraudulent acts").

176. *See id.* at 2217 (holding that reasonable limits exist as to activities that SEC can regulate under Rule 14e-3); *see also id.* at 2230 (Thomas, J., dissenting) (asserting that core acts that SEC intends to prevent through Rule 14e-3 must be fraudulent within accepted definition of that term).

177. *See id.* at 2229-30 (Thomas, J., dissenting) (presenting Government's and majority's justifications for Rule 14e-3). The Court stated that Rule 14e-3 is "a means necessary and proper to assure the efficacy of Williams Act protections." *Id.* at 2218.

178. *See id.* at 2229 (Thomas, J., dissenting) ("There being no particular difficulties in proving a breach of duty in such circumstances, a rule removing the requirement of such a breach cannot be said to be 'reasonably designed' to prevent underlying violations of the misappropriation theory.").

179. *Id.* (Thomas, J., dissenting).

180. *Id.* (Thomas, J., dissenting). Justice Thomas reasoned that proving the breach of duty would not be difficult because "it is the bidder itself that was defrauded in misappropriation cases, and there is no reason to suspect that the victim of the fraud would be reluctant to provide evidence against the perpetrator of the fraud." *Id.* (Thomas, J., dissenting). He noted further

As for the market protection justification, the SEC asserted that it designed Rule 14e-3 to address "unfair disparities in market information and market disruption."¹⁸¹ As examples of disrupting market practices, the majority noted the "stampede effect" that rumors from trading on material, non-public information might cause, and the practice of "warehousing."¹⁸² First, not all trading based on unfair disparities in market information are fraudulent acts.¹⁸³ As the Court stated in *Chiarella*, "not every instance of financial unfairness constitutes fraudulent activity."¹⁸⁴ Likewise, the stampede effect and warehousing do not involve a breach of a fiduciary duty, so a regulation designed to prevent them would not be designed to prevent fraudulent acts.¹⁸⁵ Thus, the SEC's promulgation of Rule 14e-3 with these regulatory purposes conflicts with the language of Section 14(e).¹⁸⁶ The SEC designed Rule 14e-3 to prevent acts that are not fraud; therefore, it exceeded the authority that Congress granted to the SEC in Section 14(e).¹⁸⁷

that "[e]ven where the information is obtained from an agent of the bidder, and the tippee claims not to have known that the tipper violated a duty, there is still no justification for Rule 14e-3(a)." *Id.* at 2229 n.12 (Thomas, J., dissenting). Either the tipper will say that he told the tippee that he was breaching a duty, in which case the tippee is liable under the misappropriation theory, or he will say that he falsely told the tippee that there was no breach, in which case there is a question whether the tippee did anything wrong. *Id.* (Thomas, J., dissenting). In the alternative, the SEC could eliminate the provision that the tippee know about the breach. *Id.* (Thomas, J., dissenting).

181. *See id.* at 2218 (outlining justifications for Rule 14e-3) (quoting SEC Rule 14e-3, 45 Fed. Reg. 60,412 (1980)).

182. *See id.* at 2229-30 (Thomas, J., dissenting) (restating majority's analysis of disruptive market practices). Warehousing is the practice of "a bidder intentionally tipping allies to buy stock in advance of a bid announcement." *Id.* at 2229 (Thomas, J., dissenting).

183. *See id.* at 2230 (Thomas, J., dissenting) (reasoning that not all unfair disparities in market information are result of breach of fiduciary duty).

184. *Chiarella v. United States*, 445 U.S. 222, 232 (1980).

185. *See United States v. O'Hagen*, 117 S. Ct. 2199, 2230 (1997) (Thomas, J., dissenting). Justice Thomas asserted that "[u]nfair disparities in market information, and the potential 'stampede effect' of leaks, do not necessarily involve a breach of any duty to anyone, and thus are not proper objects for regulation in the name of 'fraud' under § 14(e)." *Id.* (Thomas, J., dissenting). Furthermore, warehousing does not involve a breach of duty because the tippees are acting with the approval of the source of the material, nonpublic information. *Id.* (Thomas, J., dissenting).

186. *See id.* (Thomas, J., dissenting) (finding that "acts [do not] involve breaches of fiduciary duties, hence a Rule designed to prevent them does not satisfy § 14(e)'s requirement that the Commission's Rules promulgated under that section be 'reasonably designed to prevent' acts and practices that 'are fraudulent, deceptive, or manipulative'").

187. *See id.* at 2229-30 (Thomas, J., dissenting) (finding that SEC impermissibly designed Rule 14e-3 to prevent both fraudulent and nonfraudulent activities). Although the SEC may proscribe nonfraudulent conduct as a reasonable means to prevent fraudulent acts, the SEC does not have the power to design means intended to prevent nonfraudulent acts. *Id.* (Thomas, J.,

V. Analysis of Section 14(e) and Rule 14e-3 Under the Traditional Framework

Instead of creating its "new test," the Court should have addressed the validity of Rule 14e-3 on the basis that the SEC provided.¹⁸⁸ Rule 14e-3 states that the actions prescribed in the rule, namely the disclose-or-abstain provision, "shall constitute a fraudulent, deceptive, or manipulative act or practice within the meaning of section 14(e) of the Act."¹⁸⁹ The SEC clearly asserted its alleged power to redefine the terms "fraudulent," "deceptive," and "manipulative" in the tender offer context¹⁹⁰ in a manner contrary to their accepted meanings.¹⁹¹ Thus, in order to determine properly whether Rule 14e-3 is a valid application of the SEC's Section 14(e) rulemaking authority, one must address the definitional power argument under the Supreme Court's traditional two-step analysis.¹⁹² First, in addressing congressional intent, the language, legislative history, and policy objectives of Rule 14e-3 and Section 14(e) are all inconsistent with the proposition that the SEC may permissibly apply the disclose-or-abstain provision of Rule 14e-3 to individuals whose silence would not breach a fiduciary duty.¹⁹³ Second, regarding the reasonableness of the SEC's interpretation of its enabling statute, the promulgation of Rule 14e-3 presents a situation in which the normal deference is not appropriate.¹⁹⁴ Thus, the SEC's establishment of a parity-of-information rule through Rule 14e-3 is inconsistent with Section 14(e).¹⁹⁵

dissenting). Thus, because the SEC intended Rule 14e-3 to prevent acts that are not fraudulent, it exceeded its rulemaking authority. *Id.* (Thomas, J., dissenting).

188. See *supra* note 162 and accompanying text (describing principle of administrative law that courts must evaluate agency action on grounds that agency supplied).

189. 17 C.F.R. § 240.14e-3(a) (1997).

190. See *O'Hagan*, 117 S. Ct. at 2229 (Thomas, J., dissenting) (asserting that Rule 14e-3 is result of SEC applying defining power); Kurtz & Sleeper, *supra* note 11, at 728 (same).

191. See *United States v. O'Hagan*, 117 S. Ct. 2199, 2216-17 (1997) (summarizing Government's argument that SEC has power to define fraud in tender offer cases in manner that expands beyond common-law fraud).

192. See *supra* notes 33-40 and accompany text (discussing two-pronged test in *Chevron*).

193. See *infra* notes 196-262 and accompanying text (arguing that disclose-or-abstain requirement of Rule 14e-3 is contrary to congressional intent).

194. See *infra* notes 263-71 and accompanying text (asserting that SEC's interpretation of Section 14(e) should receive limited deference).

195. See Kurtz & Sleeper, *supra* note 11, at 725 (asserting that Rule 14e-3 creates "parity-of-information" rule). Rule 14e-3 creates the "parity -of-information" rule by:

defin[ing] 'fraudulent, deceptive, or manipulative' as the purchase or sale of a security by a person who holds material information about a tender offer that he knows or has reason to know is nonpublic and has been acquired directly or indirectly from the tender offeror, the target, or any person acting on their behalf,

A. Congressional Intent

1. Language of Section 14(e) and Rule 14e-3 and the SEC's "Defining" Power

As the Supreme Court has stated, "[a]scertainment of congressional intent with respect to the standard of liability created by a particular section of the [Securities] Acts must . . . rest primarily on the language of that section."¹⁹⁶ The language of Section 14(e) grants the SEC the power to "define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."¹⁹⁷ To ascertain whether the scope of the SEC's authority under Section 14(e) encompasses the power to create a disclose-or-abstain rule, it is necessary to determine the applicable definitions of the terms "manipulative," "deceptive," and "fraudulent."

In *Santa Fe Industries, Inc. v. Green*,¹⁹⁸ the Supreme Court asserted that the term "manipulative" "refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity."¹⁹⁹ Due to the technical meaning of this term in securities cases,²⁰⁰ the SEC could not have promulgated Rule 14e-3's

unless the information and its source are publicly disclosed before the trade.

Id.

196. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200 (1976); *see also* *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 5 (1985) (asserting that when interpreting statute, "[t]he starting point is the language of the statute").

197. 15 U.S.C. § 78n(e) (1994).

198. 430 U.S. 462 (1977).

199. *Sante Fe Indus. v. Green*, 430 U.S. 462, 476 (1977). In *Santa Fe*, the Supreme Court addressed the scope of Section 10(b) and Rule 10b-5 in a Delaware short-form merger transaction in which the majority shareholder attempted to purchase the minority shareholder interest. *Id.* at 464-65. *Santa Fe Industries, Inc.* (*Santa Fe*) controlled 95% of Kirby Lumber Co.'s (*Kirby*) stock and wished to acquire the other 5%. *Id.* at 465. To accomplish this goal, *Santa Fe* performed a Delaware short-form merger, which allows a corporation owning at least 90% of the stock of a subsidiary company to merge with the subsidiary upon approval by the parent corporation's board and cash payment for the shares owned by minority stockholders. *Id.* *Santa Fe* offered the minority shareholders \$150 per share for their Kirby stock, but the minority shareholders believed that the price was too low. *Id.* at 466-67. The minority shareholders claimed that *Santa Fe* violated Rule 10b-5 by attempting to freeze-out the minority, by obtaining fraudulent appraisals of Kirby's value, and by engaging in a deceitful scheme to mislead the minority. *Id.* at 467. The Supreme Court concluded that *Santa Fe* did not violate Rule 10b-5 because *Santa Fe*'s transaction was neither deceptive nor manipulative. *Id.* at 474. In reaching this conclusion, the Court determined that fraud in the Rule 10b-5 context mandates a showing of deception or manipulation. *Id.* at 473-74. In its interpretation of Section 10(b), the Court stated that "manipulative" meant "artificially affecting market activity in order to mislead investors." *Id.* at 477.

200. *See Ernst & Ernst*, 425 U.S. at 199 (finding that "manipulative" is "virtually a term

disclose-or-abstain provision based on Section 14(e)'s grant of power to proscribe "manipulative" acts because the Rule does not address activities intended to mislead investors by controlling the price of securities.²⁰¹ Corporate outsiders who trade in stocks based on nonpublic material information do not control stock prices and thus do not engage in "manipulative" acts.

Likewise, Rule 14e-3's disclose-or-abstain provision does not fall within Section 14(e)'s delegation of power to the SEC to prevent "deceptive" acts in the tender offer market. The dictionary defines "deceptive" as "an attempt to deceive: a declaration, artifice, or practice designed to mislead another."²⁰² At common law, an affirmative misrepresentation or half-truth upon which a person relies to his detriment or a nondisclosure in circumstances when the parties have a fiduciary relation to one another can constitute an action of deceit.²⁰³ The Supreme Court has identified two requirements for deceit in nondisclosure cases: an "omission" or "misstatement" and a breach of a fiduciary duty.²⁰⁴ Relying on these definitions of the term, the SEC's power to prevent "deceptive" acts does not authorize it to proscribe nondisclosure in the absence of a duty to reveal the information.²⁰⁵ Thus, the SEC's power to enact Rule 14e-3 without a breach of fiduciary duty requirement must lie with its authority to regulate "fraudulent" activities.²⁰⁶

of art when used in connection with securities markets").

201. See Laura Ryan, Comment, *Rule 14e-3's Disclose-or-Abstain Rule and Its Validity Under Section 14(e)*, 60 U. CIN. L. REV. 449, 486 (1991) (stating that "[b]ecause the term 'manipulative' only refers to these very limited number and types of activities, the broad proscription of Rule 14e-3(a) could not have been enacted pursuant to the SEC's power under Section 14(e) to define manipulative practices"); see also *Ernst & Ernst*, 425 U.S. at 199 (finding use of word "manipulative" "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities").

202. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 584 (1993).

203. See W. PAGE KEETON ET AL., PROSSER & KEETON ON THE LAW OF TORTS § 106, at 736-39 (5th ed. 1984) (outlining situations in which representations and nondisclosure serve as basis for common-law deceit). The elements of common law deceit are: (1) a false representation of a fact, (2) made with scienter, (3) intended to cause reliance, (4) producing justifiable reliance that (5) causes damages. See *id.* § 105, at 728 (stating elements of common-law deceit).

204. See *Santa Fe*, 430 U.S. at 474 (finding no Rule 10b-5 violation because no "misstatement" or "omission" even though Court found breach of fiduciary duty). In a nondisclosure case, because there is no communication, the misstatement prong cannot apply. See WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1536 (1993) (defining nondisclosure as "a failure to reveal facts bearing upon a transaction").

205. See Ryan, *supra* note 201, at 487 (stating that "Congress likely intended the term 'deceptive' in section 14(e) to include misrepresentations and omissions in breach of a duty to disclose[,] . . . [but] it is probable that Congress used the term 'deceptive' in Section 14(e) mainly to proscribe silence in breach of a duty to disclose").

206. See *id.* (arguing that "if rule 14e-3 is to be upheld as a valid exercise of the SEC's

At common law, silence is a fraudulent act only when there is a duty to speak.²⁰⁷ In defining fraud in nondisclosure cases, the Supreme Court determined that the existence of a fiduciary duty to disclose is a necessary prerequisite for liability.²⁰⁸ In *Chiarella*, the Court stated that "in accordance with the common law rule, . . . '[t]he party charged with failing to disclose market information must be under a duty to disclose it.'"²⁰⁹ Thus, the SEC's enactment of Rule 14e-3 with its disclose-or-abstain provision for those not in a position of trust fails to adhere to this definition.²¹⁰ Instead, in interpreting the enabling statute, the SEC disregarded the common-law meaning of the term and created a duty where one did not previously exist.²¹¹

The defenders of Rule 14e-3 argue that courts should interpret the language of Section 14(e) in a manner that does not limit the SEC to the accepted definition of fraud.²¹² Rule 14e-3's supporters believe that if the enabling act confines the SEC to the common-law meaning of fraud, then the rulemaking provision in the second sentence of Section 14(e) would be unnecessary because the SEC could not proscribe any activity not already

power to define 'fraudulent, deceptive or manipulative' acts or practices, the acts proscribed by rule 14e-3 must be 'fraudulent' actions as Congress intended the term to mean under section 14(e)".

207. See 37 AM. JUR. 2D *Fraud and Deceit* § 145, at 198-99 (1968) ("Where there is no obligation to speak, silence cannot be termed 'suppression,' and therefore is not a fraud."); Fleming James, Jr. & Oscar S. Gray, *Misrepresentation - Part II*, 37 MD. L. REV. 488, 523 (1978) ("It has often been said that there is no affirmative duty of disclosure between parties dealing at arms length"); Kurtz & Sleeper, *supra* note 11, at 725 (noting that "[a]t common law, as well as under securities law, liability for nondisclosure cases has been premised upon a duty to disclose arising from a fiduciary relationship").

208. See *Chiarella v. United States*, 445 U.S. 222, 228 (1980) (stating that "one 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").

209. See *id.* at 229 (quoting *Frigitemp Corp. v. Financial Dynamics Fund, Inc.*, 524 F.2d 275, 282 (2d Cir. 1975)).

210. See *Gustafson v. Alloyd Co.*, 513 U.S. 561, 570 (1995) (reasoning that "identical words used in different parts of the same act are intended to have the same meaning" (quoting *Department of Revenue v. ACF Indus.*, 510 U.S. 332, 342 (1994))). The Supreme Court stated that the Securities Act of 1933, "like every Act of Congress, should not be read as a series of unrelated and isolated provisions." *Id.* Thus, the courts should give the term "fraud" the same meaning for its application in both Section 14(e) and Section 10(b).

211. See *Gruenbaum*, *supra* note 11, at 353 (contending that "[b]y its adoption of the disclose or abstain from trading rule, the Commission has created what otherwise would appear to be a nonexistent duty in the context of tender offers").

212. See *United States v. Chestman*, 947 F.2d 551, 558 (2d Cir. 1991) (en banc) (finding that "[the] delegation of rulemaking responsibility becomes a hollow gesture if we cabin the SEC's rulemaking authority, as Chestman urges we should, by common law definitions of fraud").

prohibited in the first sentence of the Section.²¹³ Under this reasoning, the SEC would hold the vast power to define fraud in tender offer cases as it deems appropriate.²¹⁴

In making this argument, supporters of Rule 14e-3 misread Section 14(e). The rulemaking provision of Section 14(e) states that the SEC may define and prescribe means to prevent "such acts and practices as are fraudulent."²¹⁵ The "as are" wording of the statute limits the SEC to the accepted meaning of the term and prevents the SEC from redefining it.²¹⁶ Section 14(e) allows the SEC to elaborate and to tailor its regulations in the tender offer context,²¹⁷ but the agency's actions must be grounded in the prevailing notions of fraud.²¹⁸

213. See *SEC v. Maio*, 51 F.3d 623, 635 (7th Cir. 1995) (finding that Rule 14e-3 is valid under power granted in Section 14(e) because "[t]he power to define and prescribe means 'reasonably designed to prevent' fraudulent, deceptive, or manipulative, acts and practices must extend further than the mere proscription of acts and practices that are in fact fraudulent, deceptive, or manipulative; otherwise this language is superfluous"); *Chestman*, 947 F.2d at 558 (noting that by limiting fraud to its common law definition, "the separate grant of rulemaking power would be rendered superfluous because the SEC could never define as fraud anything not already prohibited by the self-operative provision"); Brief for the United States at 11, *United States v. O'Hagan*, 117 S. Ct. 2199 (1997) (No. 96-842) ("The 'defining' power would be a virtual nullity were the SEC not permitted to go beyond common fraud (which is separately prohibited in the first [self-operative] sentence of Section 14(e))").

214. See *Chestman*, 947 F.2d at 558 (finding that "[i]t is difficult to see how the power to 'define' fraud could mean anything less than the power to 'set forth the meaning of' fraud in the tender offer context"). Only the arbitrary and capricious standard for agency action would limit the SEC's power to define "fraud." See Administrative Procedure Act § 10(e), 5 U.S.C. § 706 (1994).

215. 15 U.S.C. § 78n(e) (1994).

216. See *United States v. O'Hagan*, 117 S. Ct. 2199, 2227 (1997) (Thomas, J., dissenting) (arguing that SEC lacks authority in Section 14(e) to redefine "fraud"). In *Schreiber*, the Supreme Court reasoned that the 1970 amendment to the Williams Act gave the SEC "latitude to regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts, without suggesting any change in the meaning of the term 'manipulative' itself." *Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 11 n.11 (1985). In light of this construction, there is no reason to believe that the Court would allow the SEC to redefine fraud or deception if it could not alter the meaning of manipulation. See *United States v. Chestman*, 903 F.2d 75, 86 (2d Cir. 1990) (Mahoney, J., dissenting) (doubting that SEC had authority to redefine term "fraudulent" after Court ruled in *Schreiber* that SEC could not change basic meaning of "manipulative"), *vacated in part en banc*, 947 F.2d 551 (2d Cir. 1991).

217. See *United States v. O'Hagan*, 92 F.3d 612, 624 (8th Cir. 1996) (stating that SEC may define acts and practices that fall within legal definition of "fraudulent"), *rev'd*, 117 S. Ct. 2199 (1997); *Chestman*, 947 F.2d at 584 (Mahoney, J., dissenting) (noting that SEC may define acts and practices that fall within legal definition of fraudulent, deceptive, or manipulative); Kurtz & Sleeper, *supra* note 11, at 725 (same).

218. See *O'Hagan*, 117 S. Ct. at 2228 (Thomas, J., dissenting) (contending that Rule 14e-3 must comply with Supreme Court precedents interpreting fraud); see also *O'Hagan*, 92 F.3d at 619 (finding that SEC has broad power to regulate tender offer field, but it may not alter

Although Section 14(e) grants the SEC broad authority to regulate tender offer situations, the government's interpretation impermissibly expands the SEC's authority.²¹⁹ Such power runs contrary to Congress's use of specific terms in its enabling statute²²⁰ and the premise that Congress should not provide administrative agencies with unrestrained authority to promulgate rules.²²¹

fixed meaning of statutory terms to do so).

219. See *United States v. Chestman*, 947 F.2d 551, 584 (2d Cir. 1991) (en banc) (Mahoney, J., dissenting) (stating that "[i]t is thus clearly unacceptable to conclude that Chestman can be validly convicted of a felony violation of section 14(e) and rule 14e-3(a) for, in the words of the majority, 'conduct outside the purview of fraud, be it common law or SEC-defined fraud'"). According to Judge Mahoney, the term "fraudulent" in the second sentence of Section 14(e) is irrelevant under the Government's reading since the statute would allow the SEC to prosecute acts that were not fraud themselves. *Id.* (Mahoney, J., dissenting). Judge Mahoney also determined that the SEC's broad authority to regulate a wide scope of "acts and practices" novel to tender offer situations "rebutts the majority's view that unless the 1970 amendment is deemed to authorize the SEC to engage in creative redefinitions of the terms 'fraudulent, deceptive or manipulative,' the amendment will become a meaningless repetition of the preexisting self-operative provisions of section 14(e)." *Id.* (Mahoney, J., dissenting).

220. See *Chestman*, 903 F.2d at 85-86 (Mahoney, J., dissenting) (stating that SEC power outlined in Section 4(e) does not include power to redefine terms), *vacated in part en banc*, 947 F.2d 551 (2d Cir. 1991). Judge Mahoney reasoned that:

Section 14(e)[']s authoriz[ation] [of] the Commission to prescribe rules which will "define . . . such acts and practices as are fraudulent, deceptive or manipulative" in the tender offer context . . . seems directed at the application of these legal concepts in a relatively novel area (especially in 1970, when Section 14(e) was amended to add this language), rather than to constitute an authorization for the Commission to redefine the meaning of the terms "fraudulent, deceptive or manipulative" as established by authoritative Supreme Court interpretations of Section 10(b) and rule 10b-5, upon which Section 14(e) is conceitedly modeled.

Id. (Mahoney, J., dissenting); see also *O'Hagan*, 92 F.3d at 624 (finding government's conflation of "the language of the statute into a broad empowerment to the SEC to 'define' and 'prescribe' 'fraud'" to be misreading of plain language of Section 14(e)); *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495, 538-39 (1935) (prohibiting "sweeping delegation[s] of legislative power" to agencies).

221. See *O'Hagan*, 117 S. Ct. at 2228 n.10 (Thomas, J., dissenting) (noting that if Court interpreted Section 14(e) in the manner in which SEC proposed, then statute "would seem to offer no 'intelligible principle' to guide the agency's discretion and would thus raise very serious delegation concerns, even under our current jurisprudence" (citing *J.W. Hampton, Jr. & Co. v. United States*, 276 U.S. 394, 409 (1928))); see also *Industrial Union Dep't v. American Petroleum Inst.*, 448 U.S. 607, 675 (1980) (Rehnquist, J., concurring) (emphasizing prohibition on Congress's "uncanalized delegations of legislative power" to administrative agencies); *Aman & Mayton*, *supra* note 26, at 30 (stating that delegations of legislative power should include discernable standards because "statutory terms should not be so open-ended as to leave an agency free to pick and choose among important social values"). If the SEC holds the power to define the terms of its enabling statute (i.e., "fraud") or regulate activities not included in the statute (i.e., acts that are not fraud but are regulated under prophylactic power),

Because Rule 14e-3 prohibits any nondisclosure when trading on tender offers rather than just fraudulent nondisclosure, Rule 14e-3 exceeds the authority that Congress granted to the SEC in Section 14(e).²²²

2. Legislative History and Intent Behind Section 14(e) and Rule 14e-3

"Reliance on legislative history in divining the intent of Congress is, as has often been observed, a step to be taken cautiously."²²³ Although the "legislative history specifically concerning § 14(e) is sparse,"²²⁴ Congress's objective in enacting the Williams Act and delegating broad rulemaking authority to the SEC was clearly to protect investors in tender offer situations through a disclosure requirement.²²⁵ There is no intelligible indication, however, that Congress intended for the SEC to expand the definition of fraud.²²⁶ If Congress resolved to grant the SEC this extensive power, it seems likely that Congress would have made some mention of it during the congressional debates addressing the Section 14(e) rulemaking provision. There was no such indication. Instead, the SEC stated that the 1970 Amendment did not

then courts will not have standards to enforce, and Congress will lose constitutionally mandated control of the agency. *See J.W. Hampton*, 276 U.S. at 409 (stating that as long as Congress "lay[s] down by legislative act an intelligible principle to which the person or body authorized to [act] is directed to conform, such legislative action is not a forbidden delegation of legislative power").

222. *See United States v. O'Hagan*, 117 S. Ct. 2199, 2228 (1997) (Thomas, J., dissenting) ("Rule 14e-3(a) does not prohibit merely trading in connection with fraudulent nondisclosure, but rather it prohibits trading in connection with *any* nondisclosure, regardless of the presence of a pre-existing duty to disclose. . . . [It] thus exceeds the scope of the Commission's authority.").

223. *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 26 (1977) (citing *Department of Air Force v. Rose*, 425 U.S. 352, 388-89 (1976) (Blackmun, J., dissenting)); *United States v. Public Utilities Comm'n*, 345 U.S. 295, 319 (1953) (Jackson, J., concurring); *Scripps-Howard Radio v. FCC*, 316 U.S. 4, 11 (1942)). *But see Schreiber v. Burlington N., Inc.*, 472 U.S. 1, 11-12 (1985) (looking to legislative history of Rule 14e-3 and Section 14(e) for guidance on Congress's objectives after analyzing their language).

224. *Schreiber*, 472 U.S. at 11.

225. *See supra* notes 60-69 and accompanying text (describing legislative history of Williams Act and its amendments); *see also Johnson & Millon, supra* note 62, at 1895-96 (stating that it is mistake "to conclude that the specific, relatively narrow shareholder protections that Congress provided [in the Williams Act] were part of some larger, well-conceived, and theoretically coherent federal policy that defines investor 'protection' in terms of an unlimited right of access to tender offer opportunities").

226. *See Kurtz & Sleeper, supra* note 11, at 726 (contending that "[w]hile it is undeniable that Rule 14e-3 effectuates a broad objective of disclosure, the scant and indefinite statements of legislative intent behind Section 14(e) do not clearly express that Congress intended to give the SEC authority to give new meaning to the term[] 'fraudulent'").

expand the rulemaking authority contained in the original Williams Act.²²⁷ Thus, because the Williams Act did not include a delegation of power that could support the validity of the SEC's promulgation of Rule 14e-3, the SEC may not interpret the 1970 rulemaking provision as authorization to create such a rule.²²⁸

The legislative histories of ITSA²²⁹ and ITSFEA²³⁰ do not sustain the validity of Rule 14e-3 either.²³¹ During its consideration of ITSA, the House

227. See *Investor Protection in Corporate Takeovers: Hearings on H.R. 4285, S. 3431, and S. 336 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 91st Cong. 4-6 (1970) (memorandum of the SEC) (outlining SEC's opinions on 1970 amendment to Williams Act). The memo reads:

As it now exists, Section 14(e) prohibits false statements and fraudulent or deceptive practices in connection with tender offers, but does not specifically grant the Commission any rule-making authority to deal with such practices. Though general authority contained in the Act could probably be relied on for this purpose, [the proposed amendment to the Williams Act] would add a sentence granting to the Commission rule-making power specifically to define and prescribe means reasonably designed to prevent fraudulent, deceptive and manipulative practices in this area.

Id. at 6.

228. See Kurtz & Sleeper, *supra* note 11, at 727 (noting SEC's assertion that its general rulemaking authority could reach Section 14(e) areas). "The SEC's interpretation of section 14(e) through Rule 14e-3, however, is a dramatic change to the SEC's rulemaking authority and one that is in stark contrast to the impression conveyed to Congress." *Id.*

229. Insider Trading Sanctions Act of 1984 (ITSA), Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.).

230. Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C.).

231. See *United States v. Chestman*, 947 F.2d 551, 559-60 (2d Cir. 1991) (en banc) (citing ITSA enactment and ITSFEA passage as support for validity of Rule 14e-3). Further, in *Chestman*, the government asserted that an SEC memorandum supports validity of Rule 14e-3. See *id.* (citing SEC memorandum to support validity of Rule 14e-3). In the memo, the SEC offered the example of a "person who has become aware that a tender bid is to be made, or has reason to believe that such bid will be made, may fail to disclose material facts with respect thereto to persons who sell to him securities for which the tender bid is to be made," as a practice in tender offers that the SEC could prevent through the rulemaking power of Section 14(e). *Additional Consumer Protection in Corporate Takeovers and Increasing the Securities Act Exemptions for Small Businessmen: Hearing on S. 336 and S. 3431 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 91st Cong. 12 (1970) (Division of Corporation Finance memorandum discussing situations that SEC's rulemaking authority under 1970 amendment would address). Because this example does not mention the need for a breach of a fiduciary duty, the Government argued that it supported the assertion that Section 14(e) does not require such a breach. See *Chestman*, 947 F.2d at 559 (noting that SEC's "hypothetical does not contain any requirement that the trader breach a fiduciary duty"). It is improper, however, "to suggest that this rough outline of a regulatory 'problem area' should be read to provide a precise delineation of the scope and purpose of the 1970

Committee on Energy and Commerce (House Committee) rejected the proposition that Congress should statutorily define insider trading because, among other reasons, "the law with respect to insider trading is sufficiently well-developed."²³² In support of this statement, the House Committee specifically cited Rule 14e-3.²³³ Similarly, the House Committee report concerning ITSFEA noted that Rule 14e-3 prompted efforts by firms "to detect insider trading and other market abuses by their employees" through self-imposed insider trading detection procedures.²³⁴ Moreover, Congress presumably approved Rule 14e-3 in its findings submitted in the ITSFEA.²³⁵ Defenders of the SEC's promulgation of the Rule reason that "[t]hese references to Rule 14e-3 during debates on proposed insider trading legislation may not amount to congressional ratification of Rule 14e-3, but they do support the Rule's validity."²³⁶

Nonetheless, courts should treat this post-adoption legislative history for what it really is – a series of inconclusive comments of limited significance. The casual references to Rule 14e-3 in the House reports and ITSFEA are not evidence of a congressional intent to accept the Rule without a requirement of a breach of a fiduciary duty.²³⁷ With regard to the ITSA House report, the

amendment." *Id.* at 585 (Mahoney, J., dissenting). Rather, courts should view this example as a "thumbnail sketch of a 'problem area,'" not as a specific grant of power that enables the SEC to ignore the plain meaning of Section 14(e)'s language and to create a disclose-or-abstain rule. *See id.* (Mahoney, J., dissenting) (reasoning that court should give SEC's example limited weight when determining congressional intent).

232. H.R. REP. NO. 98-355, at 13 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2286.

233. *Id.* at 13 n.20, *reprinted in* 1984 U.S.C.C.A.N. 2274, 2286 n.20.

234. H.R. REP. NO. 100-910, at 14 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6051.

235. *See* Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA) § 2, (noting SEC's rules and regulations under Act "governing trading while in possession of material, nonpublic information are, as required by such Act, necessary and appropriate in the public interest and for the protection of investors"); *see also* SEC v. Peters, 978 F.2d 1162, 1167 (10th Cir. 1992) (stating that "[a]dmittedly, Congress does not appear to have specifically debated Rule 14e-3 [with regard to ITSFEA], but we presume that Congress was aware of Rule 14e-3 and its implications when it made its finding").

236. *United States v. Chestman*, 947 F.2d 551, 560 (2d Cir. 1991) (en banc).

237. *See United States v. Chestman*, 903 F.2d 75, 86 (2d Cir. 1990) (Mahoney, J., dissenting) (describing limited significance of references to Rule 14e-3 in legislative histories of ITSA and ITSFEA), *vacated in part en banc*, 947 F.2d 551 (2d Cir. 1991). Judge Mahoney wrote:

In my view, the very casual references to rule 14e-3 in [the legislative histories of ITSA and ITSFEA], provide no basis for concluding that later statutory enactments have recognized not only the promulgation and existence of rule 14e-3, but also the Commission's claim that rule 14e-3 effects an implied repeal of any fiduciary duty requirement in the area of tender offer fraud.

Id. (Mahoney, J., dissenting).

House Committee mentioned Rule 14e-3 in a footnote based on a SEC letter in which the SEC fails to mention the Rule's significant alteration of insider trading law.²³⁸ This context, as well as the House Committee's unequivocal statement that ITSA "does not change the underlying substantive case law of insider trading as reflected in judicial and administrative holdings,"²³⁹ supports the argument that by referring to Rule 14e-3 in the footnote, the House Committee did not intend to approve the vast deviation from historical principles that the disclose-or-abstain rule entails.²⁴⁰

Similarly, the references to Rule 14e-3 in the ITSFEA legislative history are of little significance in assessing the intent of Congress with respect to Section 14(e). The House Committee report that mentions Rule 14e-3 also "makes clear that [ITSFEA] does not address the substantive law of insider trading."²⁴¹ Moreover, in a discussion of what constitutes insider trading, the Committee report analyzed case law concerning Section 10(b) and Rule 10b-5.²⁴² In this discussion, the report noted that liability is based on a duty to disclose and that there is no general duty to disclose material nonpublic information.²⁴³ Interestingly, the report cites Section 14(e) in the discussion, but makes no reference to Rule 14e-3 and its disregard of the breach of duty requirement.²⁴⁴

Based on this information, it seems inappropriate to assert that these references amount to any significant evidence of Congress's support of Rule 14e-3 and the SEC's interpretation of Section 14(e).²⁴⁵ Courts cannot

238. See Kurtz & Sleeper, *supra* note 11, at 727 (claiming that footnote in House Committee report was based on SEC letter that gave no indication of dramatic departure from established insider trading law principles that Rule 14e-3 encompassed). The letter is reprinted in the House Committee report. H.R. REP. NO. 98-355, at 27-33 (1983) (letter from SEC Chairman John S.R. Shad), reprinted in 1984 U.S.C.C.A.N. 2274, 2299-2306.

239. H.R. REP. NO. 98-355, at 13, reprinted in 1984 U.S.C.C.A.N. 2274, 2286.

240. See Kurtz & Sleeper, *supra* note 11, at 727 (claiming that "while Congress may have been aware of Rule 14e-3, there is no indication that Congress was aware of its significance").

241. *Chestman*, 903 F.2d at 86 (Mahoney, J., dissenting) (citing H.R. REP. NO. 100-910, at 7 (1988), reprinted in 1988 U.S.C.C.A.N. 6043, 6044).

242. H.R. REP. NO. 100-910, at 7-11, reprinted in 1988 U.S.C.C.A.N. 6043, 6044-48.

243. *Id.* at 8-10, reprinted in 1988 U.S.C.C.A.N. 6043, 6045-47.

244. *Id.* at 8, reprinted in 1988 U.S.C.C.A.N. 6043, 6045; see Kurtz & Sleeper, *supra* note 11, at 725 (stating that "[i]t is interesting to note that although section 14(e) is cited, there is no reference to Rule 14e-3 in this part of the report and the fact that it dispenses with the duty requirement").

245. *Cf. Aaron v. SEC*, 446 U.S. 680, 694 n.11 (1980) (finding fact that Congress did not overturn SEC's interpretation of statute when addressing different issues is not necessarily support for that interpretation). The Court stated that:

since the legislative consideration . . . was addressed principally to matters other

realistically read nebulous comments as expressing a discernable congressional intent to alter securities law in a manner as significant as that provided in Rule 14e-3.²⁴⁶ A deviation from precedent and common law of this magnitude requires clear evidence of congressional intent, and this legislative history does not supply such evidence.²⁴⁷

3. Policy Objectives of Section 14(e) and Rule 14e-3

By enacting Section 14(e), Congress intended for the SEC to develop rules that would protect investors in tender offer situations.²⁴⁸ The SEC was to use its expertise to determine how people commit fraud in the tender offer setting.²⁴⁹ In promulgating the overinclusive disclose-or-abstain provision in Rule 14e-3, the SEC resolved to realize this investor-protection objective through two policies: parity of information among shareholders and preservation of the integrity of the securities market (specifically the tender offers market).²⁵⁰ By creating a disclose-or-abstain rule, the SEC hoped to prevent investors with access to nonpublic information from prospering at the expense of other investors who do not have such information.²⁵¹ Likewise, if

than that at issue here, it is our view that the failure of Congress to overturn the Commission's interpretation falls far short of providing a basis to support a construction of § 10(b) so clearly at odds with its plain meaning and legislative history.

Id.

246. See Kurtz & Sleeper, *supra* note 11, at 726 (stating that "there must be clear evidence of congressional intent to sustain a construction that is contrary to the language in section 14(e) and the plain meaning of the terms 'fraudulent,' 'deceptive,' and 'manipulative'").

247. See *id.* at 730 (noting that "[s]uch a dramatic change should only be the result of clear legislative intent" and concluding that "[t]he legislative history falls far short in expressing this intent").

248. See *supra* note 62 and accompanying text (discussing investor protection as congressional objective in enacting Section 14(e)).

249. See *United States v. O'Hagan*, 92 F.3d 612, 626 (8th Cir. 1996) (reasoning that "even without the power to define fraud, [Section 14(e)] remains a very powerful tool because the SEC has broad latitude in regulating acts and practices in the wide ranging and diverse field of tender offers"), *rev'd*, 117 S. Ct. 2199 (1997).

250. See Gruenbaum, *supra* note 11, at 352-53 (stating that articulated impetus for Rule 14e-3 was "that trading by persons in possession of material, nonpublic information relating to a tender offer creates unfair disparities in information between shareholders, is disruptive to the orderly functioning of the securities markets, and has a detrimental impact on tender offer practice").

251. See Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 360 (1979) (noting that "the logic of the disclose-or-refrain rule precludes exploitation of an informational advantage that the public is unable lawfully to overcome or offset"); Heller, *supra* note 11, at 555 (asserting that "the SEC

investors believe that the markets are full of investors possessing relevant nonpublic information, they will lose confidence in the markets and refuse to invest.²⁵² Rule 14e-3, however, fails to address adequately either policy because the parity-of-information rule conflicts with Congress's approach to federal securities regulation, and little evidence exists that the Rule would have any impact on investors' perceptions of the markets.

As the Supreme Court stated in *Chiarella*, "[n]either the Congress nor the Commission ever has adopted a parity-of-information rule."²⁵³ Rather, "the problems caused by misuse of market information have been addressed by detailed and sophisticated regulation that recognizes when use of market information may not harm operation of the securities markets."²⁵⁴ This method of regulation is effective because it addresses the reality that investors inevitably possess different information which they may acquire through any number of avenues.²⁵⁵ Further, it is illogical that in Section 14(e) Congress would prohibit silence in certain personal transactions when such non-disclosure would make prior statements misleading²⁵⁶ and then would delegate authority to the SEC to implement a universal equal-access-to-information provision.²⁵⁷ Thus, Rule 14e-3's parity-of-information requirement is over-inclusive and inconsistent with Congress's "detailed and sophisticated regulation" practices.²⁵⁸

is concerned with 'fairness' to investors, that is, the availability of all information equally to all investors").

252. See *Heller*, *supra* note 11, at 555 (finding that "[t]he Commission's view has been, at least prior to *Chiarella*, that security markets will have integrity, meaning the confidence of investors, only if the investors perceive that all available information is as promptly as possible made known to all security holders equally").

253. *United States v. Chiarella*, 445 U.S. 222, 233 (1980).

254. *Id.* The Court continued: "For example, the Williams Act limits but does not completely prohibit a tender offeror's purchases of target corporation stock before public announcement of the offer." *Id.*

255. See Kenneth E. Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 805 (1980) (noting that "[i]f pushed far enough . . . it will always be found that the parties are not on a parity in all regards; there will be disparities in knowledge or intelligence or experience or capital or whatever").

256. See 15 U.S.C. § 78n(e) (1994) (stating that "[i]t shall be unlawful for any person to . . . omit to state any material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading").

257. See *Kurtz & Sleeper*, *supra* note 11, at 729 (arguing that "[i]t seems illogical for Congress to have qualified when silence is illegal in personal transactions and then grant the SEC the power to promulgate a 'parity-of-information' rule").

258. See *Gruenbaum*, *supra* note 11, at 354 (contending that "a 'parity-of-information' rule such as the new disclose or abstain from trading rule goes beyond the 'detailed and sophisticated regulation' implemented by 'Congress' [sic] careful action' in enacting the

Arguably, the disclose-or-abstain rule enhances market integrity because the public will not want to participate in the market unless they believe that they have access to material information equal to that of the other market participants.²⁵⁹ However, "no empirical evidence exists that the presence of unequal information among investors concerning securities discourages investment."²⁶⁰ Instead, a person's decision regarding whether or not to invest usually depends on "prevailing economic business and market conditions, earning trends of the company and other components of a rational analysis of securities values."²⁶¹ With regard to disparities in information, investors participate in the markets by putting their money in the hands of those with knowledge in order to take advantage of these information discrepancies.²⁶² Therefore, a parity-of-information rule does little to affect the confidences of investors as reflected in their investment practices.

Williams Act"); cf. Leuba, *supra* note 42, at 1170 (noting that Supreme Court in *Santa Fe* emphasized persuasiveness of limitations in language of Section 10(b) over concerns about market fairness when it interpreted Rule 10b-5).

259. See Cook, *supra* note 11, at 206-07 (stating that "[t]his theory posits that if people believe that the market is full of cheaters they will refrain from trading; it characterizes insider trading as a deterrent to full public participation in the stock market" (citing Roy A. Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425 (1967))).

260. Heller, *supra* note 11, at 556. Heller also asserts that "[i]t may well be doubted that investors, in fact, readily perceive any unfairness in market transactions or doubt the markets' integrity because of known differences in information available to investors." *Id.* at 555-56. Heller cites a statement by the Commissioner of the SEC which claims that insider trading constitutes "only a tiny fraction of 1 percent of the volume of trading." *Id.* at 556 (alteration in original) (quoting Kenneth B. Noble, *S.E.C. Chief Plans Inside Trade Curb*, N.Y. TIMES, Oct. 26, 1981, at D1). The statement continues: "[I]t's wrong to suggest that the public is playing a game for which the dice is loaded against them." *Id.* (quoting Kenneth B. Noble, *S.E.C. Chief Plans Inside Trade Curb*, N.Y. TIMES, Oct. 26, 1981, at D1).

261. *Id.*

262. See Cook, *supra* note 11, at 207 (asserting that "[p]eople recognize that informational discrepancies exist among traders and attempt to exploit these discrepancies by placing their investments in the hands of individuals who have greater access to information" and proffering statistic that institutions and brokerage firms account for more than 80% of New York Stock Exchange volume (citing Committee on Federal Regulation of Securities, *Report of the Task Force on Regulation of Insider Trading, Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934*, 41 BUS. LAW. 223, 226 (1985))); see also L. Gordon Crovitz, *With "Insider Trading," It's Conviction First-Definition Later*, WALL ST. J., May 9, 1990, at A15 (stating that "[f]orced equality of information is an odd idea in an industry with legions of analysts paid to ferret out information and where Moms and Pops pay mutual funds to watch markets for them").

*B. Limits on Judicial Deference to Agency Interpretations of
Enabling Statutes*

Although courts afford agencies significant deference in interpreting their enabling statutes,²⁶³ the circumstances surrounding the promulgation of Rule 14e-3 may limit the deference that courts should give to the SEC's interpretation of Section 14(e).²⁶⁴ First, such deference may not be appropriate in situations in which an agency is interpreting limits on its own statutory power such as is the case under Section 14(e) and Rule 14e-3.²⁶⁵ Second, some courts have found that Congress must provide clearer standards for an agency when a congressional delegation of authority allows the agency to promulgate regulations carrying criminal penalties.²⁶⁶ This need for specific

263. See *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984) (outlining process for courts to follow when reviewing agency's construction of its enabling statute). The Court stated that "[i]f a court, employing traditional tools of statutory construction, ascertains that Congress had an intention on the precise question at issue, that intention is the law and must be given effect." *Id.* at 843 n.9. Similarly, courts "must reject administrative constructions which are contrary to clear congressional intent." *Id.* However, if the congressional intent behind the enactment of a statute is not clear, "considerable weight should be accorded to an [agency's] construction of a statutory scheme it is entrusted to administer." *Id.* at 844.

264. See *IBT v. Daniel*, 439 U.S. 551, 566 (1979) (discussing limits on agency's interpretive role). The Court reasoned that:

This deference [due an agency] is a product both of an awareness of the practical expertise which an agency normally develops, and of a willingness to accord some measure of flexibility to such an agency as it encounters new and unforeseen problems over time. But this deference is constrained by our obligation to honor the clear meaning of a statute, as revealed by its language, purpose, and history. On a number of occasions in recent years this Court has found it necessary to reject the SEC's interpretation of various provisions of the Securities Acts.

Id. at 566 n.20 (citing *SEC v. Sloan*, 436 U.S. 103, 117-19 (1978); *Piper v. Chris-Craft Indus.*, 430 U.S. 1, 41 n.27 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 212-14 (1976); *United Hous. Found., Inc. v. Forman*, 421 U.S. 837, 858 n.25 (1975); *Blue Chips Stamps v. Manor Drug Stores*, 421 U.S. 723, 759 n.4 (1975) (Powell, J., concurring); *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418, 425-27 (1972)).

265. See Sunstein, *supra* note 32, at 467 (questioning legitimacy of deference to agency's interpretation of its own power); Braun, *supra* note 32, at 1002-07 (addressing potential for agencies to accumulate power impermissibly through interpretation of own statute).

266. See *Touby v. United States*, 500 U.S. 160, 165-66 (1991) (discussing whether "something more than an 'intelligible principle' is required when Congress authorizes another Branch [or agency] to promulgate regulations that contemplate criminal sanctions"). Compare *Fahey v. Mallonee*, 332 U.S. 245, 249-50 (1947) (stating that "discretion to make regulations . . . in [Home Owners' Loan Act] matters may be constitutionally permissible while it might not be allowable to authorize new crimes in uncharted fields") with *United States v. Grimaud*, 220 U.S. 506, 518, 521 (1911) (stating that promulgation of rule that carries criminal punishment is not "raised from an administrative to a legislative character because the violation thereof is

guidance in the enabling statute from Congress is based on the "heightened risk to individual liberty."²⁶⁷ Because a violation of Rule 14e-3 is a felony punishable by up to ten years imprisonment and a \$1,000,000 fine,²⁶⁸ simply deferring to the agency interpretation may be inappropriate in this context.²⁶⁹ Third, to rebut the plain meaning doctrine of statutory interpretation, the SEC must provide evidence of clear congressional intent to empower the SEC to disregard the common meaning of "fraud" and interpret Section 14(e) in a manner inconsistent with its language.²⁷⁰ Such evidence does not exist.²⁷¹

VI. Conclusion

The Supreme Court's ruling in *O'Hagan* is problematic. The Court deviated from precedent by upholding Rule 14e-3 on the basis of a post hoc rationalization. Under the Court's "new test" for determining the validity of agency action, a reviewing court may now turn to any grounds it can find for justification of an action. No longer does the validity of rulemaking rest on the actual rationale that the agency provides for the action.

Furthermore, the Court's analysis of the SEC's post hoc basis for Rule 14e-3 is flawed. The Government's prophylactic argument is inconsistent with the language of Section 14e-3 and the SEC's purposes for promulgating Rule 14e-3. Likewise, the SEC's defining power assertion, the actual grounds it gave for promulgating the Rule, fails to validate the action. Congressional intent and the principles of deference to agency interpretations do not support the contention that Section 14(e) grants the SEC the authority to disregard the accepted definition of fraud and to create a duty for all investors who possess material nonpublic information to either disclose the information or refrain from trading.

punished as a public offense").

267. *Touby*, 500 U.S. at 166.

268. 15 U.S.C. § 78ff(a) (1994) (defining punishment available against natural person for willful violation of Act "or any rule or regulation thereunder"). Persons other than natural persons are subject to a fine not exceeding \$2,500,000. *Id.*

269. *See Mallonee*, 332 U.S. at 249 (emphasizing need for clear congressional intent with delegation of power "to make federal crimes of acts that never had been such before and to devise novel rules of law in a field in which there has been no settled law or custom").

270. *See Aaron v. SEC*, 446 U.S. 680, 697-700 (1980) (stating that "it would take a very clear expression in the legislative history of congressional intent to the contrary to justify the conclusion that the statute does not mean what it so plainly seems to say"); Kurtz & Sleeper, *supra* note 11, at 726 (noting that evaluation of legislative history is necessary to determine if Congress intended SEC to interpret Section 14(e) in manner contrary to plain meaning of its language).

271. *See supra* notes 196-262 and accompanying text (discussing congressional intent underlying Section 14(e) and Rule 14e-3).

The SEC overstepped its rulemaking authority when it promulgated Rule 14e-3 without requiring a breach of a fiduciary duty as a predicate to liability in nondisclosure situations. Despite the Supreme Court's ruling in *O'Hagan*, the language of the enabling statute and the Rule, the legislative history behind the statute, and the policy objectives of Congress do not support the contention that Section 14(e) grants the SEC the authority to act in such a manner. O'Hagan's, Chestman's, Maio's, Ladavac's, and Peters's actions may be wrong. Nonetheless, if Congress desires to implement a disclose-or-abstain rule for tender offers, then it must make that intent clear in an enabling statute. Because such congressional intent is absent, the *O'Hagan* Court erred by not striking down the SEC's promulgation of Rule 14e-3 as an ultra vires usurpation of power.