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Kramer Ortman

SEC V. BAUER: IF THE GLOVE FITS, IT'S INSIDER TRADING

Kramer Ortman[+]

"Insider trading is one of the few issues in securities regulation that has become a matter of cultural symbolism as well as legal controversy."[1] The public and the media are often captivated by stories of large-scale insider trading and corporate fraud schemes.[2] However, the United States Securities and Exchange Commission (SEC) has recently dedicated itself to cracking down on such fraud, regardless of the size.[3] Through this increased effort, the SEC is bringing insider trading claims under factual scenarios that highlight fraudulent activity in the evolving financial world, despite not exactly fitting the molds established by precedent.[4] A federal court, in *SEC v. Bauer*, explored, but left unresolved, the threshold issue of whether the theories of insider trading may be used to impose liability under Section 10(b) of the Securities Exchange Act of

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+ J.D. and Securities Law Program Certificate Candidate, May 2015, The Catholic University of America, Columbus School of Law; B.A., 2011, Gonzaga University. The author would like to thank Professor David A. Lipton for his invaluable expertise and suggestions throughout the writing process. He would also like to thank his wife, Sydney, for her constant love and support and his parents, Chet and Jenny, for their encouragement and guidance. Finally, he would like to thank the members of the *Catholic University Law Review* for their help with this Note.

1. 18 DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT & PREVENTION § 1.1 (2013).

2. *See* Kathleen Coles, *The Dilemma of the Remote Tippee*, 41 GONZ. L. REV. 181, 181 (2006) (stating that despite the public's typically fluctuating interest in insider trading, recent events have recaptured the public's attention due to the prominent corporations and individuals involved, such as the Enron debacle and the Martha Stewart scandal); *see also* Peter S. Goodman, *Insider Trading: 'Steal A Lot, They Make you King'*, HUFFINGTON POST, http://www.huffingtonpost.com/2010/11/22/insider-trading_n_786969.html (last updated May 5, 2011, 2:59 PM) (stating that the Bernie Madoff case attracted vast public interest because the nation could easily identify the wrongdoer with the financial crisis); *see also* Linda Chatman Thomsen, Director, Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Remarks Before the Australian Securities and Investments Commission 2008 Summer School: U.S. Experience of Insider Trading Enforcement (Feb. 19, 2008) (transcript available at http://www.sec.gov/news/speech/2008/spch021908lct.htm) (arguing that the public's fascination with insider trading stems from the desire to understand what occurrence or characteristic, aside from greed, led successful, hard-working businessmen and women to commit such grandiose crimes).

3. *See SEC Enforcement Actions: Insider Trading Cases*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/spotlight/insidertrading/cases.shtml (last modified Oct. 25, 2013) (explaining that insider trading violations remain a high priority for the SEC's enforcement division). The SEC brought fifty-eight insider trading actions in the fiscal year 2012. *Id.* In the three-year span from 2009 to 2012, the SEC filed 168 insider trading actions, which amounts to more actions than in any previous three-year period. *Id.*

4. *See, e.g.*, United States v. O'Hagan, 521 U.S. 642, 659–60 (1997) (endorsing the misappropriation theory of insider trading to comport to the alleged fraudulent activity even though that activity would not constitute insider trading under prior Supreme Court case law).

1934 (the Exchange Act) in connection with the redemption of mutual fund shares for the first time.[5]

Insider trading is the "purchase or sale of securities, with scienter (or guilty knowledge), while in possession of material, non-public information in breach of a duty arising out of a fiduciary relationship."[6] Although insider trading is not explicitly proscribed in the statutes relating to general securities law,[7] the underlying elements in all insider trading offenses are (1) the use of any "manipulative or deceptive device," (2) "in connection with the purchase or sale of any security," in contravention of rules promulgated by the SEC.[8] The courts and the government have developed two prosecutorial theories of insider trading to determine guilt that include these elements.[9]

The two theories of insider trading liability are the "classical theory" and the "misappropriation theory."[10] The classical theory describes a violation of insider trading laws by corporate insiders[11] who trade in their corporation's own securities on the basis of material, nonpublic information.[12] In contrast, the misappropriation theory describes a violation by persons, generally corporate outsiders, who misappropriate securities trading information given to them in trust by the source of the information.[13] These theories represent two possible fact patterns that establish a basis for insider trading causes of action.[14]

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5. SEC v. Bauer, 723 F.3d 758, 769 (7th Cir. 2013) (noting that no federal court has ruled on the issue whether traditional insider trading theories apply to mutual fund redemptions).

6. Thomsen, *supra* note 2.

7. *See* Randall W. Quinn, *The Misappropriation Theory of Insider Trading in the Supreme Court: A (Brief) Response to the (Many) Critics of* United States v. O'Hagan, 8 FORDHAM J. CORP. & FIN. L., 865, 868 (2003) (discussing how section 10(b) of the Securities Exchange Act is the only federal securities provision expressly prohibiting insider trading). *See* 15 U.S.C. § 78p(b) (2012) (requiring corporate insiders to return profits made through certain trades within a six month period); *see also* RALPH C. FERRARA, DONNA M. NAGY & HERBERT THOMAS, FERRARA ON INSIDER TRADING AND THE WALL § 1.02 [1][a] (2010) (describing section 16(b) as restricting corporate insiders from unfairly benefiting from "short swing" trading profits).

8. Securities Exchange Act of 1934, ch. 404, § 10(b), 48 Stat. 881, 891 (codified as amended at 15 U.S.C. § 78j(b) (2012)).

9. Quinn, *supra* note 7, at 869 (defining both the classical theory and misappropriation theory used to prosecute insider trading).

10. *Id.*

11. "Corporate insider" has commonly been defined to include "officers, directors, or controlling stockholders." Cady, Roberts & Co., Exchange Act Release No. 6668, 1961 WL 60638, at *3 (Nov. 8, 1961). However, the application of the classical theory has been extended to include, aside from traditional corporate insiders, any actors who hold momentary fiduciary duties to a corporation, such as attorneys or consultants. United States v. O'Hagan, 521 U.S. 642, 652 (1997) (citing Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983)).

12. *See infra* Part I.B.1 (tracking the development of the classical theory through case law).

13. *See infra* Part I.B.2 (describing the creation of the misappropriation theory).

14. *See infra* Parts I.B.1–2 (examining the fact patterns of cases charged using both insider trading theories).

In *Bauer*, the SEC struggled to apply either theory to the facts of the case.[15] *Bauer* arose after the SEC questioned the redemption of mutual fund shares by an account executive.[16] Claiming that the redemption violated insider trading laws, the SEC pursued legal action against Jilaine H. Bauer.[17] The SEC originally won summary judgment, but dropped its classical theory liability argument on appeal, in favor of the alternative misappropriation theory.[18] Although the Seventh Circuit expressed some skepticism regarding the applicability of the misappropriation theory to the mutual fund context, the court did not outright reject the possibility that the SEC may utilize section 10(b) in this context.[19]

This Note examines the novel issue of whether insider trading law can apply to a mutual fund executive who, with approval for the trade, redeems shares within the fund during an open trading window period. First, this Note summarizes the relevant prior history of insider trading and then provides a background of *Bauer*. After establishing these bases, this Note analyzes the application of insider trading law to *Bauer*. Then, this Note first argues that the misappropriation theory applies within the context of redeeming shares in a mutual fund. Second, it argues that the SEC can prove Bauer's guilt using the necessary elements of insider trading theory.

I. INSIDER TRADING LIABILITY, THE "ANTI-FRAUD" PROVISIONS OF SECURITIES LAW, AND FURTHER CASE LAW DEVELOPMENT

A. *The Statutory Basis for Insider Trading and the "Anti-Fraud" Provisions*

Although no statutes specifically proscribe insider trading in the United States, the primary statutory and regulatory bases for barring such conduct are "the 'anti-fraud' provisions of Section 10(b) of the Securities Exchange Act, . . . Rule 10b-5 issued under that Act, and Section 17(a) of the Securities Act of

15. *See infra* note 18 and accompanying text (citing the change in theory used by the prosecution to convict Bauer).

16. SEC v. Bauer, 723 F.3d 758, 762 (7th Cir. 2013).

17. *Id.*

18. *Id.* at 767, 769–70.

19. *Id.* at 772.

1933."[20] Section 10(b)[21] and Rule 10b-5[22] prohibit fraud in connection with the purchase or sale of a security.[23] Specifically, Section 10(b) outlaws the use of any deceptive device to buy or sell securities.[24] Adopted by the SEC pursuant to its rulemaking power under section 10(b), Rule 10b-5 makes it unlawful to "employ any device, scheme, or artifice to defraud."[25] Additionally, the SEC can also bring charges for insider trading based on Section 17(a).[26] Whereas Section 10(b) and Rule 10b-5 apply to situations involving a security's "purchase or sale,"[27] Section 17(a) prohibits fraud in the "offer or sale of any securities."[28]

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20. Cady, Roberts & Co., Exchange Act Release No. 6668, 1961 WL 60638, at *1 (Nov. 8, 1961).

21. 15 U.S.C. § 78j(b) (2012). Section 10(b) states that:

> 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 . . . [t]o 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, or any securities-based swap agreement any manipulative 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.

22. 17 C.F.R. § 240.10b-5 (2013). Rule 10b-5 provides that:

> 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 material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

Id.

23. *See supra* notes 21–22 and accompanying text.

24. 15 U.S.C. § 78j(b).

25. 17 C.F.R. § 240.10b-5(a).

26. 15 U.S.C. § 77q(a) (2012). Section 17(a) provides that:

> It shall be unlawful for any person in the offer or sale of any securities . . . by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Id.

27. 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5(c).

28. 15 U.S.C. § 77q(a).

B. Common Law Development of Insider Trading Law in the United States

Insider trading law further developed through judicial interpretation of the anti-fraud provisions.[29] Courts generally interpret these provisions to require deceptive conduct in order to find an insider trading violation.[30]

The preeminent authority interpreting the anti-fraud provisions is *In the Matter of Cady, Roberts & Co.*[31] In that case, the SEC found willful violations of the anti-fraud provisions when a broker-dealer and his firm sold securities based upon undisclosed information obtained from the director of the issuer, who was also an associate in the firm.[32] The SEC held that corporate insiders have two options when trading in shares of their own corporation.[33] The corporate insiders must either disclose all personally-known material information prior to conducting such trades or abstain from trading.[34] *Cady, Roberts* also imposed a duty to disclose upon insiders with respect to both purchasing and selling the corporation's shares.[35]

1. The Classical Theory

The Supreme Court continued the statutory interpretation debate and endorsed the classical theory of insider trading in *Chiarella v. United States*.[36] Under the classical theory, a corporate insider violates the anti-fraud provisions by trading in the corporation's securities "on the basis of material, non-public information"

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29. *See* Ted Kamman & Rory T. Hood, *With the Spotlight on the Financial Crisis, Regulatory Loopholes, and Hedge Funds, How Should Hedge Funds Comply with the Insider Trading Laws?*, 2009 COLUM. BUS. L. REV. 357, 363–64 (2009) (stating that case analysis and application of insider trading laws exemplifies the common law development of legal theory); *see also* Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1322–23 (2009) (explaining that courts play a critical role in defining the law of insider trading in the United States, due to the absence of a statute specifically banning insider trading).

30. Nagy, *supra* note 29, at 1322–23.

31. *See* Cady, Roberts & Co., Exchange Act Release No. 6668, 1961 WL 60638, at *3 (Nov. 8, 1961) (noting that the legislators enacted securities laws to ensure honesty and transparency in the purchase and sale of securities); *see also* Joseph J. Humke, Comment, *The Misappropriation Theory of Insider Trading: Outside the Lines of Section 10(b)*, 80 MARQ. L. REV. 819, 824 (1997) (noting the significance of the *Cady* decision).

32. *Cady, Roberts & Co.*, 1961 WL 60638, at *1–2.

33. *Id.* at *3.

34. *Id.* This obligation arises from the duty to disclose typically reserved for corporate insiders, such as directors or stockholders, which requires disclosing material information. *Id.* Courts have generally held that "insiders must disclose all material facts which are known to them by virtue of their position but which are not to known to persons with whom they deal and which, if known, would affect their investment judgment." *Id.* *See also* Chiarella v. United States, 445 U.S. 222, 227–29 (1980) (expanding upon the common law rationale for this obligation).

35. *Cady, Roberts & Co.*, 1961 WL 60638, at *3 (stating that investors who buy shares from corporate insiders are entitled to the same protections that require insiders to disclose special information in their possession, as those who sell shares to the insiders).

36. *Chiarella*, 445 U.S. at 230, 234–35 (rejecting a broad statutory interpretation that would include corporate outsiders in those groups with fiduciary duties to the corporation).

about the corporation.[37] In *Chiarella*, the Supreme Court imposed this requirement specifically on corporate insiders.[38] The Court held that Section 10(b) and Rule 10b-5 did not impose a duty to disclose on those individuals who possessed material, nonpublic information.[39] However, the Court found that the fiduciary duties that corporate insiders owe to the corporation and its shareholders included the duty to either disclose all such information prior to trading or abstain from trading in the company's stock.[40]

Although *Chiarella* established this duty for corporate insiders, the Court exempted traders that owed no fiduciary duties to the corporation or its shareholders from liability.[41] The defendant, in *Chiarella*, was neither a corporate officer nor an employee of the company whose shares were traded.[42] Rather, Chiarella was an employee of a company hired to print five announcements of various corporate takeover bids.[43] Despite the masked identity of the companies involved within the documents given to the printer, Chiarella managed to decipher the identity of the "target companies" from additional information contained within the documents.[44] After acquiring this information, but before the announcements were printed, Chiarella bought stock in the target companies.[45] Chiarella later sold the shares after the corporate takeover bids were publicized and made a profit of roughly $30,000.[46]

The Court rejected the notion that there was "a general duty between all participants in market transactions to forgo actions based on material, nonpublic information."[47] Therefore, the Court held that Chiarella had not violated any securities laws under the classical theory of insider trading.[48] The Court restricted the scope of insider trading liability to situations where the insider had "a duty to disclose arising from a relationship of trust and confidence between

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37. United States v. O'Hagan, 521 U.S. 642, 651–52 (1997).

38. *Chiarella*, 445 U.S. at 228–29. The court stated:

> [T]he duty to disclose arises when one party has information that the other party is entitled to know because of a fiduciary or other similar relation of trust and confidence between them. . . . [A] relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation. This relationship gives rise to a duty to disclose because of the necessity of preventing a corporate insider from . . . taking unfair advantage of the uninformed minority stockholders.

Id. (footnotes omitted) (internal quotation marks omitted) (original alterations omitted).

39. FERRARA, *supra* note 7, at § 2.02 [3].

40. *See Chiarella*, 445 U.S. at 227; *see also Cady, Roberts & Co.*, 1961 WL 60638, at *3.

41. *Chiarella*, 445 U.S. at 232.

42. *Id.* at 231.

43. *Id.* at 224.

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.* at 233 (giving the Court's reasoning for rejecting the petitioner's arguments).

48. *Id.* at 235.

parties to a transaction," such as that held by corporate officers, directors, and shareholders.[49]

However, since *Chiarella*, the duty to disclose or abstain under the classical theory of insider trading is no longer limited to traditional corporate insiders, such as officers and directors. The Supreme Court in *Dirks v. SEC*,[50] in dicta, extended this duty to outsiders who can obtain status as "temporary insiders."[51] This theory extends insider trading liability to outsiders "clothe[d] . . . with temporary insider status when the outsider obtains access to confidential information solely for corporate purposes in the context of a special confidential relationship."[52] Because of this corollary status, the temporary insider acquires a fiduciary duty to both the corporation and its shareholders.[53] Because a duty exists in these situations, the temporary insider can be held liable under the classical theory of insider trading.[54]

2. *The Misappropriation Theory*

The Supreme Court endorsed a second theory to attach insider trading liability in *United States v. O'Hagan*: the misappropriation theory.[55] According to the misappropriation theory, a person violates the anti-fraud provisions by

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49. *Id.* at 230. The Court refused to entertain the notion of the misappropriation theory because the SEC only presented it on appeal, just like in *Bauer*. *See Counterattack From the Supreme Court:* Chiarella v. United States, SEC. & EXCHANGE COMMISSION HIST. SOC'Y, http://www.sechistorical.org/museum/galleries/it/counterAttack_b.php (last visited June 7, 2014) ("[Justice] Powell discovered that this 'misappropriation' argument had not been presented to the jury, and he persuaded the Supreme Court to refuse to consider the theory in the case.").

50. 463 U.S. 646 (1983). *See infra* Part 1.B.3 (exploring tipper-tippee liability).

51. *Dirks*, 463 U.S. at 655, n.14 (establishing the parameters of the temporary insider's role); United States v. Chestman, 947 F.2d 551, 565 (2d Cir. 1991) (en banc) (noting the influence of the *Dirks* decision).

52. *Chestman*, 947 F.2d at 565 (internal quotations omitted).

53. *See Dirks*, 463 U.S. at 655 n.14.

> Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes. . . . For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.

Id. *See also* United States v. O'Hagan, 521 U.S. 642, 652 (1997) (explaining that a temporary fiduciary duty may extend to outside service providers).

54. *See O'Hagan*, 521 U.S. at 652; *see also supra* note 11 and accompanying text.

55. 521 U.S. 642 (1997). Although *O'Hagan* endorsed the misappropriation theory, the theory existed as an avenue to insider trading violations long before 1997. *See* Kamman & Hood, *supra* note 29, at 374 n.39 (stating that the origins of the misappropriation theory go as far back as the dissent in *Chiarella*, after which the United States Court of Appeals for the Second Circuit endorsed the theory).

misappropriating confidential information for securities trading purposes, in breach of a duty owed to the source of the information. Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information.[56]

Whereas the classical theory imposes a duty upon corporate insiders, the misappropriation theory imposes a duty upon corporate "outsiders."[57] Thus, the misappropriation theory protects against abuses by outsiders, who owe no fiduciary duty to the corporation, from using confidential information to profit from changes in stock prices.[58] The breach can occur at a different time than the actual trade, as long as it somehow relates to the trade.[59]

In *O'Hagan*, an attorney purchased common stock and call options of a potential takeover target based upon nonpublic information.[60] O'Hagan learned of the potential takeover from confidential information obtained through his law firm, which represented the company planning the tender offer.[61] Because O'Hagan was neither an officer nor had any relation the target company, the classical theory of insider trading did not apply.[62] The Court nevertheless held that O'Hagan was guilty of insider trading, because he owed a fiduciary duty to his law firm, and when he used his law firm's confidential information to trade,

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56. *O'Hagan*, 521 U.S. at 652 (citation omitted).

57. *See id.*, 521 U.S. at 652–53 (stating that the misappropriation theory "outlaws trading on the basis of nonpublic information by a corporate 'outsider' in breach of a duty owed not to a trading party, but to the source of the information").

58. *See id.* at 653. The SEC issued Rule 10b5-2 to identify some of the circumstances under which a duty of trust or confidence arises such that its breach would constitute a misappropriation of confidential information. These circumstances include:

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

17 C.F.R. § 240.10b5-2 (2013).

59. The anti-fraud provisions make no mention of any time limitation imposed on acquiring the material nonpublic information and the purchase or sale of a security while using that information. *See* 15 U.S.C. §§ 77q(a) (2012), 78j(b) (2012); *see also* 17 C.F.R. 240.10b-5.

60. *O'Hagan*, 521 U.S. at 647–48.

61. *Id.*

62. *Id.* at 653 n.5.

he misappropriated such information.[63] Therefore, the Court held that a corporate outsider is guilty of insider trading in connection with securities "when he misappropriates confidential information for securities trading purposes, in breach of a fiduciary duty owed to the source of the information," rather than to the persons with whom he trades.[64]

3. Tipper-Tippee Liability

Without establishing a new theory of insider trading, the Court expanded the concept of liable parties under the current theories of insider trading through "tipper-tippee" liability.[65] Insider trading is not limited to corporate insiders who personally trade in securities based upon any inside information that they have acquired through normal fiduciary means.[66] Under "tipper-tippee" liability, a corporate insider may be found guilty of insider trading by passing along inside information and "tipping" others to trade on the basis of this information.[67] If the "tippee" trades on such information, knowing that the tipper's disclosure of such information breaches a duty, then the tippee also violates federal securities laws.[68]

The Supreme Court illustrated this theory in *Dirks v. SEC*.[69] In *Dirks*, the Court addressed the issue of insider trading in the case of a securities analyst who received troubling information about a corporation and shared it with investors.[70] The former insider, Ron Secrist, had been employed by a life insurance company controlled by Equity Funding Life Insurance Corp.[71] Dismayed at what he believed to be massive fraud by his former employer, he contacted Dirks, an analyst who specialized in insurance companies.[72] Secrist did not have direct evidence for his allegations, but Dirks was impressed enough to conduct his own inquiries.[73] Dirks, in turn, found sufficient support for

63. *Id.* at 653–54, 666.

64. *Id.* at 652.

65. *See* Dirks v. SEC, 463 U.S. 646, 660 (1983) (noting that tippees take on fiduciary duties based on confidential information they occasionally learn through inappropriate channels, which bars them from trading on such information).

66. *See id.* (stating that tippees receiving information from an insider take on the insider's duty to the corporation and the shareholders).

67. *See id.* at 659–60 (observing that corporate insiders may not give information to outsiders).

68. *See id.* at 659–60, 664 (stating that "the tippee inherits the duty to disclose or abstain").

69. *Id.* at 659–64 (discussing the potential liability of recipients of confidential information for trading on that information).

70. *Id.* at 648–49.

71. *Id.* at 649.

72. *Id.* at 648–49.

73. *Id.* at 649.

Secrist's claims of fraud and Dirks' findings ultimately reached the SEC.[74] In addition, he discussed his findings with various clients, some of whom traded on the information.[75] The SEC brought charges against Dirks and some of Equity Funding's insiders.[76] Dirks appealed.[77]

In *Dirks*, the Court articulated the general rule of law for "tipper-tippee" liability: "Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain."[78] Accordingly, the Court found that the non-insider tippee "assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information . . . when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."[79] However, in order for a tippee to be found guilty of insider trading, the insider who passed along the information must "benefit, directly or indirectly, from his disclosure."[80]

The Court, applying the tipper-tippee rule of law to the facts of *Dirks*, found that the insider who provided Dirks the information did not benefit from the disclosure.[81] Rather, the insider disclosed the confidential information in order to expose apparent fraud within the company.[82] Because the insider did not "benefit, directly or indirectly from his disclosure,"[83] the Court held that the

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74. *Id.* at 649–50 (stating that after Dirks spread the word of his findings, particularly through contacting newspapers, and after the stock price fell over forty percent, the SEC began to investigate Equity Funding and, ultimately, Dirks).

75. *Id.* at 649.

76. *Id.* at 650–52 (recognizing Dirks' key role in unveiling the fraud and bringing reduced charges as a result).

77. *Id.* at 652.

78. *Id.* at 659 (explaining the need to attach liability to tipper-tippee trading).

79. *Id.* at 660. The Court further explained that a tippee's responsibility requires that the tippee knew that the confidential information that the tippee received violated an assumed fiduciary duty. *Id.* at 661 (quoting *In re* Investors Mgmt. Co., Securities Act Release No. 9267, 44 S.E.C 633, 651 (1971)).

80. *Id.* at 662 (establishing the test for liability in tipper-tippee trading cases).

81. *Id.* at 666–67 & n.27 (deciding that no breach of fiduciary duty to the company's shareholders existed).

82. *Id.* (finding that the insider's intent in sharing information with Dirks was to reveal fraud, not to perpetuate fraudulent investments).

83. *See id.* at 662, 666 n.27.

insider had not breached a duty to the company's shareholders.[84] Therefore, the Court decided that the tippee could not be held liable for insider trading.[85]

C. The Necessary Elements of Insider Trading

1. Scienter

Regardless of the applicable insider trading theory, a violation of insider trading laws requires that a person act with scienter.[86] Scienter is defined as "a mental state embracing intent to deceive, manipulate, or defraud."[87]

In *Ernst & Ernst v. Hochfelder*,[88] the Supreme Court considered the requisite state of mind required to prove civil liability under Rule 10b-5.[89] In this case, the president of a bank engaged in a fraudulent investment scheme that involved his conversion of customer funds for personal use.[90] The accounting firm, Ernst & Ernst, was accused of negligence with regard to its auditing duties to the bank.[91] The Court found that the negligence claims could not support liability because Section 10(b) requires intentionality in order to establish scienter.[92] In reaching this conclusion, the Court noted that the "manipulative or deceptive" language used with "device or contrivance" in Section 10(b), strongly suggested

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84. *See id.* at 666 (stating that the insiders breached no duty to shareholders). The Court decided *Dirks* under the classical theory of insider trading. *See id.* at 657–59 (discussing in detail the application of the classical theory as developed by *Chiarella*); *see also supra* Part I.B.1 (tracking the development and definition of the classical theory). A person could also theoretically "tip" another person based on misappropriated information. The Supreme Court has not yet ruled on whether the *Dirks* principles apply to trading based on the misappropriation theory. *See* FERRARA, *supra* note 7, at § 2.02 [6][D][iv] (stating that in *O'Hagan*, the Court did not decide whether the misappropriation theory applied to a tip based on misappropriated information). On the other hand, the lower courts have not hesitated to find tipping liability in misappropriation cases. *See id.* However, there is a split over whether the requirement of a personal benefit to the tipper applies within this theory. *Compare* SEC v. Yun, 327 F.3d 1263, 1275 (11th Cir. 2003) (requiring the SEC to prove that one who misappropriated the information expected to benefit from the tip), *with* SEC v. Musella, 748 F. Supp. 1028, 1038 n.4 (S.D.N.Y. 1989) (stating that liability under the misappropriation theory does not require that the tipper benefit from the tip).

85. *Dirks*, 463 U.S. at 666.

86. In *Aaron v. SEC*, the Supreme Court decided whether the SEC needed to establish scienter as an element of an enforcement action brought under the federal securities laws anti-fraud provisions. 446 U.S. 680, 686 (1980). Based on the statutory language and the legislative history, the Court found that those bringing claims under Section 10(b) and Rule 10b-5 must prove scienter regardless of the plaintiff and relief sought. *Id.* at 691.

87. *Id.* at 686 n.5 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193–94 & n.12 (1976)) (discussing whether plaintiffs may bring claims under section 10(b) and Rule 10b-5 without establishing scienter).

88. 425 U.S. 185 (1976).

89. *Id.* at 187–88.

90. *Id.* at 189.

91. *Id.*

92. *Id. See also* Sunstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1043–44 (7th Cir. 1977) (stating that negligence does not give rise to a Section 10(b) claim).

that Congress intended the statute to require knowing or intentional misconduct.[93]

Although the Supreme Court determined that the anti-fraud provisions required some form of intentionality to prove the element of scienter,[94] what form the intent must take remains unclear.[95] The Court has not answered this question, but lower courts overwhelmingly say that recklessness is sufficient to prove scienter.[96] However, many of these courts continue to hold that recklessness entails a subjective aspect related to purposefully avoiding the truth.[97]

Courts in the Seventh Circuit have interpreted intentionality to include recklessness.[98] In *Sundstrand Corp. v. Sun Chemical Corp.*,[99] the United States Court of Appeals for the Seventh Circuit determined that "a reckless omission of material facts upon which the plaintiff put justifiable reliance in connection with a sale or purchase of securities is actionable under Section 10(b) as fleshed out by Rule 10b-5."[100] The court, in *Sundstrand*, defined recklessness as:

> [A] highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.[101]

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93. *Ernst & Ernst*, 425 U.S. at 197 (explaining that the words are not ambiguous, but necessitate that the statute must be read to require intent).

94. *See id.* at 189.

95. *See* Donald C. Langevoort, *What Were They Thinking? Insider Trading and the Scienter Requirement*, 3 (Georgetown Publ. Law & Legal Theory, Research Paper No. 12-111, 2012), *available at* http://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=2018&context=facpub (noting the lack of clarity over the meaning of intentionality and discussing whether recklessness is sufficient).

96. *Id.* at 3–4. *See also* WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING, § 4.4.2 (1996) (discussing the requirements to prove scienter under Section 10(b) and Rule 10b-5). The Supreme Court has noted that all lower courts find scienter present with intentionality and recklessness, but that the level of recklessness required differs depending on the circuit. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 n.3 (2007). In *Tellabs*, the degree of recklessness necessary to satisfy the scienter requirement was not presented for the Supreme Court to decide. *Id.*

97. Langevoort, *supra* note 95, at 3–4.

98. *See e.g.*, SEC v. Bauer, 723 F.3d 758, 775 (7th Cir. 2013). Bauer's case is being prosecuted in the United States Court of Appeals for the Seventh Circuit. As such, its case law governing the required elements of insider trading governs the application of insider trading to *Bauer*.

99. 553 F.2d 1033 (7th Cir. 1977).

100. *Id.* at 1044.

101. *Id.* at 1045 (quoting Franke v. Midwestern Okla. Dev. Auth., 428 F. Supp. 719, 725 (W.D. Okla. 1976) *vacated by* Cronin v. Midwestern Okla. Dev. Auth., 619 F.2d 856, 864 (10th Cir. 1980)). The Seventh Circuit's definition of recklessness is the one most commonly followed across the jurisdictions. *See* LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES

The court analogized fraud under Rule 10b-5 to common law fraud to reach the conclusion that recklessness was sufficient to establish a cause of action.[102] According to the Seventh Circuit, "[a]t common law reckless behavior was sufficient to support causes of action sounding in fraud or deceit," therefore, "it would be highly inappropriate to construe the Rule 10b-5 remedy to be more restrictive than its common law analogs."[103]

2. Materiality

Because the anti-fraud provisions prohibit the use of "any untrue statement of a material fact" or the exclusion of "a material fact necessary in order to make the statements made . . . not misleading,"[104] materiality is a frequently disputed element discussed in insider trading cases.[105] The Supreme Court entered the debate about the definition of materiality for the purposes of Rule 10b-5 in *Basic Inc. v. Levinson*.[106] In *Basic*, former employees of Basic sued the company claiming Section 10(b) and Rule 10b-5 violations after they sold their company shares at exaggeratedly low prices in a market where Basic's misleading statements kept the stock price depressed.[107] The claimants argued that Basic violated the anti-fraud provisions by repeatedly claiming that they were not privy to merger negotiations, when in fact a merger was developing during this time.[108] Less than two months after Basic's last statement denying a merger, Basic merged with another company and announced the deal the following day.[109]

In assessing whether the denial of discussions related to a possible merger was material within the context of federal securities laws, the Court stated that information is deemed material if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[110] The Court found no valid reason to exclude discussions concerning possible

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REGULATION 843 (3d ed. 1995); *see also* 141 CONG. REC. 7245 (1995) (statement of Rep. Blilely) (stating the importance of the *Sundstrand* definition of recklessness).

102. *Sundstrand*, 553 F.2d at 1044.

103. *Id.*

104. 15 U.S.C. § 77q(a) (2012); 17 C.F.R. § 240.10b-5 (2013).

105. *See e.g.,* Basic Inc. v. Levinson, 485 U.S. 224, 226 (1987) (discussing the materiality requirement).

106. *Id.*

107. *Id.* at 228.

108. *Id.* at 227–28. In three separate statements following heavy days of trading of Basic stock and inquiries into the matter, Basic denied that it had knowledge of any forthcoming business developments that could explain the stock activity. *See id.* at 227 n.4 (stating that the company did not know of any events that would affect its trading activity).

109. *Id.* at 227–28. Basic's last statement denying a possible merger was issued to its shareholders on November 6, 1978. *Id.* at 227–28 n.4. The merger deal was endorsed by Basic on December 19, 1978. *Id.* at 228.

110. *Id.* at 231–32 (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

mergers, but it did not develop a bright-line rule for assessing materiality.[111] Rather, the Court held that "[a]ny approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive."[112] As such, materiality includes a subjective and objective assessment.[113]

3. *"On the Basis of"*

Another element required for insider trading is that the person charged must trade in reliance on, or "on the basis" of, material, nonpublic information.[114] Under Rule 10b5-1, this requirement is met if the person trading was aware of the material, nonpublic information.[115] However, the rule also sets forth several affirmative defenses or exceptions to liability.[116] Rule 10b5-1 allows persons to trade in certain, specified circumstances where it is clear that the information

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111. *Id.* at 236 (stating that although a bright-line rule may be easier to follow and to apply, "ease of application alone is not an excuse for ignoring the purposes of the Securities Acts and Congress' policy decisions").

112. *Id.*; *see also TSC Indus.*, 426 U.S. at 450 (stating that "[t]he determination [of materiality] requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him, and these assessments are peculiarly ones for the trier of fact"); Selective Disclosure and Insider Trading, 65 Fed. Reg. 51716, 51721 (Aug. 24, 2000) (to be codified at 17 C.F.R. pts. 240, 243, & 249) ("While we acknowledge in the Proposing Release that materiality judgments can be difficult, we do not believe an appropriate answer to this difficulty is to set forth a bright-line test, or an exclusive list of 'material' items for purposes of Regulation FD.").

113. *See Basic*, 485 U.S. at 236. By not mandating a bright-line rule for determining the materiality of a statement or omission, the Court utilized a subjective test. *Id.* This subjective test allows courts to scrutinize different factual scenarios in order to determine the "fact-specific finding" of materiality. *Id.* However, the test is not limited to a subjective component; rather, in formulating the rule, the Court included an objective standard as well. *See id.* at 231–32. The Court "expressly adopt[ed] the *TSC Industries* standard for materiality," which required a determination of whether the "reasonable investor" would deem the statement or omission "as having significantly altered the total mix of information" available to the public. *Id.* at 231–32 (quoting *TSC Indus.*, 426 U.S. at 449) (internal quotation marks omitted).

114. 17 C.F.R. § 240.10b5-1(a)–(b) (2013); *see also* United States v. O'Hagan, 521 U.S. 642, 651–52 (1997) (discussing the elements of both the classical and misappropriation theories of insider trading).

115. 17 C.F.R. § 240.10b5-1(b). "[A] purchase or sale of a security of an issuer is 'on the basis of' material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale." *Id.* Congress passed Rule 10b5-1 to resolve the federal circuit splits about whether the courts should look to either "possession" or "use" of material nonpublic information as an appropriate standard in insider trading cases. Jennifer L. Neumann, *Insider Trading: Does "Aware" Really Resolve the "Possession" Versus "Use" Debate?*, 7 WASH. U. J.L. & POL'Y 189, 189 (2001). The basis for Rule 10b5-1 is found in case law. *See* Freeman v. Decio, 584 F.2d 186, 197 n.44 (7th Cir. 1978) (explaining that although insiders immediately selling a large portion of their stock followed by the public disclosure of information that leads to a decrease in the company's stock price gives rise to the inference that the insider was acting upon the information, the inference can be negated by a showing that the sales were consistent with past sales or occurred pursuant to a plan).

116. 17 C.F.R. § 240.10b5-1(c).

they possess is not a factor in the decision to trade, such as pursuant to a pre-existing plan, contract, or instruction that was made in good faith.[117] However, not all jurisdictions strictly adhere to Rule 10b5-1's possession requirement.[118]

Courts must examine the necessary elements and the established precedents, along with the specific facts of the case, to determine whether a theory of insider trading applies. If applicable, the defendant must be found guilty of insider trading.

II. THE CASE OF *BAUER*

A. Events Leading Up to Prosecution

Jilaine Bauer (Bauer) is a securities lawyer who was once employed by Heartland Advisors, Inc. (HAI).[119] HAI managed the portfolios for Heartland Group, Inc. (HGI), which served as the underwriter and distributor of HGI's mutual fund shares (Funds).[120] During the relevant time period, Bauer served in various high-level company management and board positions for both HAI and HGI.[121]

In 1999 and continuing through Bauer's redemption of her shares, the Funds experienced significant liquidity problems caused by substantial redemptions and by a growing number of bonds in the Funds' portfolio that either defaulted or were placed on a possible default "watch list."[122] In addition, HAI struggled to sell the Funds' securities at book value, which led to further concerns regarding the Funds' valuation and the discussion of price reductions.[123] In the midst of these problems, one of the Fund managers tendered his resignation.[124] Bauer subsequently put trading restrictions in place for all HAI personnel who

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117. *Id.* (naming elements of the affirmative defenses to Rule 10b5-1).

118. *See* Audrey Strauss, *Recent Insider Trading Jury Charges: 'Possession' vs. 'Use'*, N.Y. L.J., July 7, 2011, at 5, 7 (explaining that Congress' adoption of Rule 10b5-1 did not seem to resolve the "possession" v. "use" debate). Rather, recent jury instructions in the Second Circuit have broken away from the awareness requirement; instead, the courts have instructed juries that they must find that the defendant actually used the information. *Id.*

119. SEC v. Bauer, 723 F.3d 758, 762 (7th Cir. 2013). HAI is both an investment adviser and a broker-dealer. *Id.*

120. *Id*. HGI is an open-end management investment company. *Id.* A mutual fund is a collection of financial assets, primarily securities, that belongs to the individual investors who hold ownership shares in the fund. Jones v. Harris Assoc. L.P., 559 U.S. 335, 338 (2010) (citing Burks v. Lasker, 441 U.S. 471, 480 (1979)). The Funds included the "Short Duration Fund" and the "High Yield Fund." *Bauer*, 723 F.3d at 762.

121. *Bauer*, 723 F.3d at 762. During this time period, Bauer served as general counsel, chief compliance officer, senior vice president, and secretary for HAI. *Id.* In 2000, Bauer also served as chairperson of HAI's Pricing Committee. *Id.* She was also vice president and was elected secretary of HGI. *Id.*

122. *Id.* at 763–64.

123. *Id.* at 764.

124. *Id.* In order to create a transition plan, the manager and the Board agreed to defer the resignation until late September 2000. *Id.*

had become aware of the tendered resignation.[125] The Board and the Pricing Committee regularly met during this time period to discuss options to deal with the Funds' pricing and liquidity problems.[126]

At the end of September 2000, HAI issued a press release announcing the departure of the Fund manager and the hiring of a replacement.[127] Bauer lifted the previously imposed trading restrictions after informing HGI's board, its independent counsel, the President of both HAI and HGI, and the Vice President and Chief Operating Officer of HAI of the Fund manager's departure.[128] A few days later, Bauer phoned in her order to redeem all of her shares in the Short Duration Fund for $44,627.15.[129] During the phone call, Bauer identified herself by name and stated that she was an HAI employee.[130] The Funds' problems continued, and approximately two weeks after Bauer's redemption, HAI instituted widespread cuts that resulted in a drastic drop to the Funds' net asset values (NAVs).[131] Several months later, the Funds entered receivership.[132]

B. Trial Proceedings

The SEC sued Bauer for insider trading and other securities law violations in December 2003.[133] In May 2011, the district court granted the SEC summary judgment on the insider trading charges.[134] Bauer appealed.[135]

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125. *Id.* While serving as chief compliance officer, Bauer instituted the company's policy against insider trading, which prohibited HAI employees from trading in securities that the Fund held on the basis of confidential information. *Id.* at 762.

126. *Id.* at 764–67 (tracking the meetings and reporting the discussions that took place).

127. *Id.* at 765.

128. *Id*. at 766.

129. *Id.*

130. *Id.*

131. *Id.* at 767. The "haircuts" resulted in a drop in the Short Duration Fund's NAV by over forty-four percent, and a drop in the High Yield Fund's NAV by over sixty-nine percent. *Id.*

132. *Id.* Receivership is a form of bankruptcy whereby the courts or creditors appoint a receiver to oversee the company's bankruptcy proceedings. *Receivership*, INVESTOPEDIA, http://www.investopedia.com/terms/r/receivership.asp (last visited June 8, 2014). The receiver may be appointed by a court or governing body. *Id.* The receiver has the authority to make decisions on behalf of the company and decides how to manage and distribute the company's assets. *Id.*

133. *Bauer*, 723 F.3d at 767. All of the related defendants to the case except Bauer came to an agreement with the SEC and settled their claims out of court. *Id.*

134. *Id.* The district court granted summary judgment based on the stipulation that Bauer was an insider in possession of confidential information when she redeemed her shares and because there was no genuine dispute of material fact with respect to the materiality and scienter elements. *Id.* In September 2011, the district court dismissed all of the remaining claims originally brought against Bauer. *Id.*

135. *Id.*

C. The Appeal

Despite winning summary judgment by advancing the classical theory of insider trading, the SEC changed tactics on appeal.[136] The SEC dropped the classical theory and argued only the misappropriation theory.[137]

The Seventh Circuit, in its opinion, acknowledged that this action was unique because it was "one of the few instances in which the SEC has brought insider trading claims in connection with a mutual fund redemption."[138] The court explained that "[n]o federal court has directly opined on the applicability of insider trading prohibitions to the trade of mutual fund shares,"[139] primarily because "the SEC has never brought a § 10(b) claim in the mutual fund context."[140] The court went on to state several critical observations.

First, the Seventh Circuit noted that the district court did not properly understand the uniqueness of the claims and the "threshold" legal issues.[141] More specifically, the district court did not consider "whether, and to what extent, the [classical and misappropriation] insider trading theories apply to mutual fund redemptions."[142] Second, the court observed that although the district court relied on the classical theory of insider trading, it "did not, however, weigh the novelty of the SEC's claims in the mutual fund context."[143] Third, the Seventh Circuit found that the misappropriation theory had never been presented to the district court.[144]

Accordingly, the Seventh Circuit reversed and remanded the case for several reasons.[145] Regarding the question of whether Bauer's conduct constituted deception under insider trading theories, the court declined to consider the classical theory of insider trading because the SEC failed to argue the issue on appeal.[146] With respect to the misappropriation theory, the Seventh Circuit held

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136. *Id.* at 770. The court disagreed with the SEC's argument that at the district court level, it did not choose between the classical or misappropriation theory. *Id.* at 770 n.4. The SEC argued that they put Bauer on notice that she could be held liable for either theory. *Id.*

137. *Id.* at 769–70.

138. *Id.* at 762.

139. *Id.* at 762.

140. *Id.* at 769.

141. *Id.* at 762.

142. *Id.* at 769. Based on this omission, the district court had not been called upon to categorize Bauer's conduct as violating either insider trading theory. *Id.* at 771.

143. *Id.* at 770. By failing to weigh the novelty of the claim, the district court did not describe how the classical theory applied to mutual fund redemptions. *Id.*

144. *Id.* Because the district court had not been presented with an argument regarding the application of the misappropriation theory, the Seventh Circuit had been asked to affirm summary judgment based on a theory of insider trading that was never presented to the district court and on a district court opinion that failed to consider whether either the classical or misappropriation theory applies to mutual fund redemptions. *Id.*

145. *Id.* at 762.

146. *Id.* at 771. The court found that by not briefing the court on the classical theory, the SEC forfeited its ability to argue the theory. *Id.*

that it would be "fundamentally unfair" to deprive Bauer of the opportunity to fully develop arguments and present evidence regarding that theory.[147] Given the novelty of the issue presented, the court further reasoned that remand was warranted.[148] Although it expressed some skepticism regarding the SEC's position, the court clarified that it was not denying the applicability of an insider trading claim involving the buying and selling of mutual fund shares based on the misappropriation theory.[149]

Even though the Seventh Circuit did not rule on the applicability of the misappropriation theory, its decision to remand the case highlighted the importance of the opinion. The court allowed the district court to opine on the misappropriation theory first.[150] By doing so, the appellate court secured the right to review the lower court's decison rather than serving as the sole adjudicator of the issue and risking a final decision on such a novel issue.[151]

III. THE REDEMPTION OF BAUER'S MUTUAL FUND SHARES AS A VIOLATION OF FEDERAL SECURITIES LAWS

The policy rationales underlying the prohibitions against insider trading are centered on the principles of fairness, efficiency, and market integrity.[152] Based on these principles, insider trading law operates to prevent fraud, manipulation, and deception in the capital markets.[153] Courts remember these policies when deciding whether an individual's acts constitute insider trading.[154] Although the classical and misappropriation theories, in their current form, have allowed courts to more easily determine whether a factual scenario amounts to a violation of insider trading, insider trading cannot be forced into a predetermined mold.[155]

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147. *Id.*

148. *Id.* at 772. The court stated that even if the parties present the same evidence, the district court judge should rule on the issue before the appellate court decides whether the misappropriation theory applies. *Id.* at 771.

149. *Id.* at 772 (stating the court is seeking clarity to understand how the elements of insider trading might arise in the mutual fund redemption context).

150. *Id.* at 771–72, 777 (citing the novelty of the issue among reasons for its decision to remand the case).

151. *See id.* at 771, 777 (remanding the case to the district court for further proceedings).

152. 15 U.S.C. § 78b (2012) (discussing why it is necessary to regulate the securities and exchange markets); *see also* Freeman v. Decio, 584 F.2d 186, 189 (7th Cir. 1978) (noting a policy argument about how insider trading is unfair to other investors and should be discouraged).

153. Joan MacLeod Heminway, *Materiality Guidance in the Context of Insider Trading: A Call for Action*, 52 AM. U. L. REV. 1131, 1169 (2003) (discussing the underlying policy reasons for insider trading anti-fraud provisions).

154. *See* Chiarella v. United States, 445 U.S. 222, 246–47 (1980) (Blackmun, J., dissenting) (arguing that when flexibly construing the anti-fraud provisions, it is important that a court's ruling is consistent with the purposes of the federal securities laws).

155. *See* Nagy, *supra* note 29, at 1317–20. The Supreme Court in *O'Hagan* reversed twenty years of Supreme Court precedent that took a narrow view of the federal securities laws, especially Section 10(b). Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading*

Therefore, the courts must recognize the flexibility of the doctrine and appreciate the underlying policy rationales when applying the current theories of insider trading to Bauer's factual scenario.[156]

A. The SEC Correctly Abandoned the Classical Theory of Insider Trading on Appeal

Even though the SEC abandoned the classical theory on appeal, and the Court of Appeals supported the logic of this decision,[157] the impact on future cases makes it necessary to understand why the classical theory cannot apply to the facts of Bauer. The classical theory targets a corporate insider who breached a duty to the corporation with which the insider traded and that corporation's shareholders.[158] The court found Bauer to be a corporate insider, and as such, she owed a fiduciary duty to the counterparties of the transaction.[159]

Under the classical theory, Bauer must have either disclosed all information in her possession regarding the transaction to the counterparty or abstained from trading in the Fund for the transaction to be legal and to not violate insider trading law.[160] The counterparty to Bauer's redemption, in the transaction under investigation, was the mutual fund itself.[161] However, requiring disclosure to

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*Liability: A Post-*O'Hagan *Suggestion*, 59 OHIO ST. L.J. 1223, 1244–45 (1998) (discussing United States v. O'Hagan, 521 U.S. 642, 651 (1997)).

156. *See O'Hagan*, 521 U.S. at 651 (stating that Section 10(b) of the Exchange Act is not limited to deceiving a purchaser or seller of securities, but applies to any deception "in connection with the purchase or sale of any security") (quoting 15 U.S.C. § 78j(b) (2012)) (internal quotation marks omitted); *see also Chiarella*, 445 U.S. at 246–47 (Blackmun, J., dissenting) (stating that federal securities laws must be interpreted flexibly). The text of the anti-fraud provisions reflects the expansiveness of the rules. The text prohibits "*any* person . . . in connection with the purchase or sale of *any* security" from employing "*any* manipulative or deceptive device or contrivance in contravention of" SEC rules. 15 U.S.C. § 78j(b) (emphasis added). The repeated use of the word "any" is important when applying the rules to various factual scenarios. *See* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972) (stating that the word "any" designates that the anti-fraud provisions must be viewed broadly and inclusively); *see also* Nagy, *supra* note 155, at 1296 n.344 (highlighting that federal securities laws must be interpreted flexibly to cover all the activities that Congress intended to prevent) (quoting *Affiliated Ute Citizens of Utah*, 406 U.S. at 151).

157. SEC v. Bauer, 723 F.3d 758, 770–71 (7th Cir. 2013).

158. *O'Hagan*, 521 U.S. at 651–52; *see also supra* Part I.B.1 (discussing the classical theory of insider trading).

159. SEC v. Bauer, No. 03-C-1427, 2011 LEXIS 56780, at *36 (E.D. Wis. May 25, 2011) (finding that Bauer qualified as an insider when she engaged in the trading activity in question), *rev'd*, 723 F.3d 758 (7th Cir. 2013). The appellate court noted that the SEC and Bauer both agreed that at the time of the transaction in question, Bauer was an insider. *Bauer*, 723 F.3d at 770. At the district court, the SEC made no attempt to expand Bauer's role from a traditional insider of HAI, but acting as an outsider, to HGI in her redemption of her fund shares. *Id.*

160. *See supra* note 38 and accompanying text (stating that the duty for corporate insiders under the classical theory established by the *Chiarella* court).

161. *See* Reply Brief of Defendant-Appellant at 5, SEC v. Bauer, 723 F.3d 758 (7th Cir. 2013) (No. 12-2860), 2012 WL 6563351, at *5 (stating that a mutual fund is the redeeming party's counterpart).

the counterparty would not make sense if the counterparty knew all of the material information because the purpose of the disclosure is to ensure that all parties to the transaction are equally informed.[162] In Bauer's case, the executives who ran the mutual fund had all of the material information that Bauer had in her possession.[163] Consequently, nondisclosure to the mutual fund would not create unfairness within the transaction between the two parties.[164] Bauer did not take advantage of increased information then available to the counterparty.[165] Therefore, Bauer argued the classical theory could not be the basis for an insider trading violation.[166]

Although the Court of Appeals did not rule on whether the classical theory could apply in the mutual fund context,[167] the court's reasoning and the SEC's decision to abandon this theory on appeal showed that the classical theory did not accurately apply to the facts of *Bauer*.[168] Additionally, the SEC's abandonment of a theory after advancing it for twelve years illuminates the SEC's struggle to find a viable theory of insider trading on which to convict Bauer.[169]

B. The Misappropriation Theory and Its Application to Bauer

On appeal, the SEC changed its argument to rely upon the misappropriation theory.[170] The misappropriation theory targets persons, insiders or outsiders,[171]

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162. *See* Cady, Roberts & Co., Exchange Act Release No. 6668, 1961 WL 60638, at *4 (Nov. 8, 1961) (recognizing the unfairness of insider trading because it allows one party to benefit based on information that is not available to other parties).

163. *See Bauer*, 723 F.3d at 764–67 (stating all of the information Bauer possessed and discussed with the Board in relation to the problems with the mutual funds).

164. *Id.* at 771 (stating that "the mutual fund [] is always fully informed and cannot be duped through nondisclosure"); *see also* Reply Brief of Defendant-Appellant, *supra* note 161, at 5 (arguing that it would be illogical for insiders to disclose information to the mutual fund).

165. *See supra* note 162 and accompanying text.

166. *Bauer*, 723 F.3d at 771 (summarizing Bauer's reasoning against the applicability of the classical theory). For the classical theory to better fit this transaction, the theory would need to be expanded within the context of mutual funds to include protections for those shareholders owning portions of the fund. If the misappropriation theory did not support remedial claims for these shareholders, this would be an interesting expansion of the classical theory, giving it a much broader effect. This expansion argument is similar to the argument that seeks to expand the class of breached fiduciaries under the misappropriation theory. *See* Nagy, *supra* note 155, at 1309–10 (arguing that the misappropriation theory should not solely be based on a breach to the source of the information, but rather a breach to all securities holders of the company holding the information).

167. *Bauer*, 723 F.3d at 771 (declining to examine whether the classical theory applies because the SEC did not raise the issue in its briefs).

168. *See supra* notes 157–58 and accompanying text.

169. *Bauer*, 723 F.3d at 770–71.

170. *Id.* at 771; *see also* Brief of the Sec. & Exch. Comm'n, Appellee at 29, SEC v. Bauer, 723 F.3d 758 (7th Cir. 2013) (No. 12-2860), 2012 WL 6018890, at *29.

171. The misappropriation theory is commonly phrased to target corporate outsiders. *See* United States v. O'Hagan, 521 U.S. 642, 652–53 (1997) (stating that "the misappropriation theory

who misuse confidential information within the context of trading securities "in breach of a duty . . . owed to the source of the information."[172] In remanding the case, the Court of Appeals did not rule out the applicability of the misappropriation theory.[173] The misappropriation theory's broad scope can be applied to hold Bauer liable under insider trading law for redeeming her shares.[174]

Bauer does not initially appear to be an outsider and does not fit the class of persons commonly found guilty under the misappropriation theory.[175] Based on this fact alone, the misappropriation theory should not apply to Bauer.[176] However, as stated in *Dirks*, theories of insider trading can expand to fit individuals with a particular status into a theory of insider trading.[177] As such, the misappropriation theory should not be discounted solely because the court found Bauer to be a corporate insider.[178]

In order to determine whether the misappropriation theory applies to Bauer's transaction, the court must judge whether Bauer's redemption of the Fund shares violates the purpose of this theory.[179] The misappropriation theory is designed to "protect the integrity of the securities markets against abuses by outsiders" who owe a duty to the source of the information and not the shareholders.[180] Because the duty is to the source of the information, disclosure to the source of the information prevents deception.[181] Without deception, no fraud exists and

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outlaws trading on the basis of nonpublic information by a corporate 'outsider'"). However, the theory is not limited in this sense. Rather, the use of "outsiders" is meant to reflect the misappropriation theory's contrasting and much broader application than the classical theory. *See* Nagy, *supra* note 155, at 1307–10 (highlighting the breadth of the misappropriation theory's possible interpretations).

172. *O'Hagan*, 521 U.S. at 653.

173. *Bauer*, 723 F.3d at 772. In its opinion, the Court of Appeals highlighted the questionable conduct of Bauer, and through the remand, invited the SEC to introduce the misappropriation theory to the district court rather than have the appellate court issue a ruling on a theory that had not been applied and adjudicated in the case at hand. *Id.* at 772–73.

174. *See infra* notes 197–205 and accompanying text (discussing why the misappropriation theory can be applied to Bauer).

175. *See Bauer*, 723 F.3d at 772 (remarking upon the intense level of involvement that investment advisors have with the funds they manage).

176. *See O'Hagan*, 521 U.S. at 653 (discussing how the misappropriation theory applies to corporate outsiders who do not owe a fiduciary duty to the corporation's shareholders).

177. *See supra* notes 51–53 and accompanying text.

178. There has been debate concerning the definition of fraud in the insider trading context. *See* Samuel W. Buell, *What is Securities Fraud?*, 61 DUKE L.J. 511, 514–17 (2011) (highlighting the uncertainty about when fraud applies to securities law). However, if fraud is seemingly apparent, the exact status or title of a person should not shield her from liability.

179. *See O'Hagan*, 521 U.S. at 652–53 (describing the circumstances to which the misappropriations theory applies).

180. *Id.* at 653 (alteration in original) (internal quotation marks omitted).

181. *See* SEC v. Obus, 693 F.3d 276, 285 (2d Cir. 2012) (discussing an insider's duty to disclose or abstain from trading when the insider possesses confidential information, so that the insider does not breach the insider's fiduciary duty).

one cannot be held liable for insider trading.[182] Here, Bauer identified herself as an HAI employee by name during her redemption.[183] Bauer disclosed her identity over the phone to an operator, but did not inform the Board of her intention to redeem all of her shares.[184] Because the Board is the source of the information, Bauer would need to disclose to the Board in order to prevent deception.[185] Under this analysis, it appears that Bauer's redemption of her shares breached her duty to the mutual fund.[186] Therefore, the misappropriation theory should apply to Bauer's actions.[187]

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182. *See* Laura D. Mruk, *The Proverbial Axe to the Judicial Oak: The Impact of* Stoneridge *on Plaintiff's Actions Under § 10(b)*, 29 N. ILL. U. L. REV. 281, 297 (2009) (stating that at common law, on which section 10(b) is based, deception was broad enough to include misleading conduct and the act of concealing information).

183. *See supra* note 132–33 and accompanying text.

184. SEC v. Bauer, 723 F.3d 758, 766 (7th Cir. 2013) (describing the phone call Bauer made to redeem her shares and not describing any actions Bauer took to tell the Board of her redemption).

185. The Board is the source of the information, because the Board maintained all of the discussions regarding the various problems affecting the mutual fund. *See id.* at 764–67 (describing the Board's meetings to address the Fund's problems).

186. Because Bauer became aware of the material information through the Board, the information is to be used solely by the Board to manage and price the Funds and not for the personal benefit of one of the Board members. *See id.* (describing how Bauer came into contact with the information through the Board); *see also* United States v. O'Hagan, 521 U.S. 642, 653–54 (1997) (explaining the company's nonpublic information is the type of property over which a company has exclusive rights).

187. It should also be noted that if it is determined that the classical and the misappropriation theories cannot be applied to convict Bauer of insider trading, the SEC is not limited to the current theories of insider trading. *See supra* note 157 and accompanying text. Rather, these theories were developed as various ways to interpret the anti-fraud provisions. *See* Thomsen, *supra* note 2 (explaining that court interpretations of Section 10(b) and Rule 10b-5 have had a significant impact in shaping and changing the contours of insider trading). As witnessed in *O'Hagan*, the courts may endorse new theories based on the arguments advanced. *O'Hagan*, 521 U.S. at 653–54; *see also* FERRARA, *supra* note 7, at § 2.02 [7] (discussing a third theory of insider trading accepted by the Second Circuit that based liability on acquiring material nonpublic information by fraudulent means). However, in the past, the Court has found limitations when interpreting the anti-fraud provisions. *See* Chiarella v. United States, 445 U.S. 222, 234–35 (1980) (stating that although Section 10(b) may be viewed broadly, it is limited to prosecuting fraud consistent with the statute's language and purpose) (quoting Toche Ross & Co. v. Redington, 442 U.S. 560, 578 (1979)); *see also* Thomsen, *supra* note 2 (highlighting the flexibility of insider trading while acknowledging the limits of existing law and the importance of new laws in society). The Court endorsed the misappropriation theory in *O'Hagan* because the issue in question involved the statutorily required deceptive conduct "in connection with" the purchase or sale of securities. *O'Hagan*, 521 U.S. at 659. To successfully advance a new theory, the SEC would have to argue a theory that would encompass the necessary elements. *See supra* Parts I.C.1-3 (defining the elements of insider trading); *see also Chiarella*, 445 U.S. at 234–35 (refusing to apply a new theory of liability that did not meet the necessary elements established by Section 10(b)). The theory would also have to advance the principals established originally in *Cady, Roberts* and followed subsequently by the Court in *Chiarella*. The two elements from *Cady, Roberts* for establishing a Rule 10b-5 violation are: "(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.

C. The Necessary Elements of Insider Trading Exist in Bauer

1. The Redemption Was "on the Basis of" Nonpublic Information

Rule 10b5-1 establishes that trading meets this required element if the person was aware of the information when the trading occurred.[188] In Bauer's case, Bauer was aware of the Fund's liquidity and management struggles.[189] Therefore, the fact pattern satisfies this element, unless Bauer can claim an affirmative defense or exception to the rule.[190] Bauer moved to nullify the inference of insider trading by attempting to justify her redemption on various factors, including a planned move to California pursuant to new employment and a personal struggle with the volatility of the Fund.[191] If the court accepted these reasons as true, Bauer's redemption could qualify for an exception.[192] However, the court would not likely reach this conclusion given the timing of the redemption and the fact that Bauer had yet to be offered a job in California.[193]

2. The Information Traded on Is Material

Any claim of insider trading must involve the defendant trading on material information.[194] Here, Bauer failed to divulge her knowledge of the management and liquidity struggles of the Fund.[195] Although this fact is no doubt material, "[a]n insider of an open-end fund generally would not be able to exploit insider information . . . because an open-end fund is required to price its shares . . . at NAV."[196] This means that the mutual fund must be priced daily in order to

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188. 17 C.F.R. § 240.10b5–1(b) (2013).

189. *See Bauer*, 723 F.3d at 769 (stating that Bauer attended a board meeting, where the board discussed the Funds' problems); *see also supra* notes 124–27 and accompanying text.

190. 17 C.F.R. § 240.10b5–1(c) (outlining affirmative defenses that individuals may use to avoid liability).

191. Reply Brief of Defendant-Appellant, *supra* note 161, at 20, 2012 WL 6563351, at *20.

192. *See* 17 C.F.R. § 240.10b5–1(c)(1)(i)–(ii) (explaining the circumstances that alleviate liability from trading "on the basis" of certain information).

193. Brief of Sec. & Exch. Comm'n, Appellee, *supra* note 170, at 47–49, 2012 WL 6018890, at *47–49.

194. *Bauer*, 723 F.3d at 768–69 (citing SEC v. Monarch Funding Corp., 192 F.3d 295, 308 (2d Cir. 1999) (stating that the SEC must prove that Bauer made a material misrepresentation or omission)).

195. *See Bauer*, 723 F.3d at 766 (describing Bauer's knowledge of the Funds' problems, but saying nothing about Bauer disclosing this knowledge).

196. Select Sector SPDR Trust, SEC No-Action Letter, 3, 1999 WL 185555, at *3 (May 6, 1999). NAV stands for "net asset value." *See* 17 C.F.R. § 270.22c-1(a) (describing redemption based on net asset value); *see also* Mercer E. Bullard, *Insider Trading in Mutual Funds*, 84 OR. L. REV. 821, 824-25 (2005).

> When calculating a fund's net asset value, its portfolio securities must be valued, if 'market quotations are readily available,' at their *current* market value. If market quotations are not readily available, portfolio securities must be valued based on their 'fair value as determined in good faith by the [fund's] board of directors.' Funds choose the time or times of day as of which they price their shares, but in practice, virtually all

reflect all available information to the pricing committee.[197] Therefore, Bauer cannot be held liable for insider trading under either theory, unless she knew that the Funds were mispriced.[198]

However, Bauer and the Board knew that the Fund's problems would continue to result in redemptions.[199] There would be no drastic change in price, until these redemptions actually occurred.[200] By possessing this information, Bauer was able to redeem her personal shares before the other customers in the Fund redeemed their shares, thus saving her roughly $20,000.[201] In light of these circumstances, the information that Bauer possessed was likely to be considered material.[202]

3. *Bauer Acted with Scienter*

The court must assess whether Bauer had the intent to deceive, or in other words, whether she knew what she was doing, in order to determine if she acted with the necessary level of scienter.[203] As stated in *O'Hagan*, full disclosure removes the finding of scienter.[204] Bauer did not fully disclose, but she could not have intended to deceive the Fund because the Board approved removing the restriction on trading for HAI employees.[205] As the trading window was open, Bauer did nothing wrong in doing what all HAI employees had permission to

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> funds price their shares once a day as of 4:00 p.m. eastern standard time. Fund shares must be sold by the funds and their distributors at their per share NAV, and there is no secondary market for fund shares. This means that all fund sales and redemptions occur at their per share NAV.

Id. at 824–25 (alteration in original) (footnotes omitted) (quoting 17 C.F.R. 270.2a-4(a)(1) (2005)).

197. Bullard, *supra* note 196, at 824–25.

198. Bauer did not discuss information with the Funds' pricing services or participate in valuation discussions. SEC v. Bauer, No.03-C-1427, 2011 U.S. Dist. LEXIS 56780, at *11–12 (E.D. Wis. May 25, 2011). Instead, Bauer notified the Board about the pricing service's concerns about the Funds' NAV, but had difficulty assigning the securities a fair value. *Id.* at *25–26. However, in the end, the pricing committee decided to use the third party pricing services valuations because such valuations appeared to represent the fair value of the securities. *Id*. at *26–27.

199. Brief of Sec. & Exch. Comm'n, Appellee, *supra* note 170, at 35–36, 2012 WL 6018890, at *35–36 (quoting Bauer's email to the Board positing that liquidation may be the only answer to the Fund's continuing problems).

200. *Bauer*, 723 F.3d at 766–67 (describing the Fund's problems and the decision to suspend redemptions).

201. *See id.* at 767 (discussing the changing in share prices and Bauer's redemption of her shares before sending an email to make the information public).

202. *See supra* Part I.C.2 (discussing the element of materiality).

203. *See supra* Part I.C.1 (discussing the element of scienter).

204. United States v. O'Hagan, 521 U.S. 642, 655 (1997) (citing Santa Fe Indus. v. Green, 430 U.S. 462, 474, 476 (1977)) (distinguishing the facts under the misappropriation theory with another case that found no liability because the defendants had publicly disclosed all material information and, therefore did not violate section 10(b) and Rule 10b-5's provisions requiring deception).

205. *Bauer*, 723 F.3d at 766, 771 (citing Bauer's email encouraging HAI to disclose).

do.[206] When she redeemed her shares, she identified herself.[207] On their face, her actions do not appear to have the intention to deceive.[208]

However, with recklessness available as the threshold to prove scienter,[209] the SEC is more likely to establish this element "so long as they can persuade the fact-finder of the defendant's greedy character or disposition."[210] In *Bauer*, this approach appears to be a reasonable objective for the SEC. The SEC should be able to paint the picture of Bauer as a greedy executive by focusing on the fact that Bauer redeemed her shares while in possession of material information, and that she saved herself $20,000 at the expense of other holders of the Fund.[211]

IV. CONCLUSION

Although *SEC v. Bauer* brought forth the novel issue of whether insider trading applies in the mutual fund context, the court cannot constrict its view of insider trading so narrowly as to discount Bauer's conduct. As this Note explains, the misappropriation theory applies to Bauer, and her actions fit the required elements of insider trading. However, an important fact-specific question remains because scienter is arguably proved under the standard of recklessness. On remand, the district court should accept the misappropriation theory as applicable to Bauer, but should allow a jury to determine the question of fact regarding whether she acted with the requisite level of scienter. By allowing the misappropriation theory to apply to mutual fund share redemptions, the court will ensure that an entire class of investment vehicles is afforded the same protections against insider trading as more traditional investment opportunities, such as stock purchases. As the financial investment world continues to diversify and evolve, it is essential that protections exist to encourage investment and to promote the integrity of the markets.

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206. *Id.* at 771.

207. *Id.* at 766.

208. *See* Reply Brief of Defendant-Appellant, *supra* note 159, at 18–20, 2012 WL 6563351, at *18–20 (arguing that the trading window was open, that she had personal reasons to redeem her shares in the mutual fund, and that these reasons were not based on an intent to deceive her employer or the mutual fund).

209. *See supra* note 96 and accompanying text.

210. Langevoort, *supra* note 95, at 5 (putting the burden of persuading a jury of greed on the prosecution).

211. *See* Brief of Sec. & Exch. Comm'n, Appellee, *supra* note 170, at 34, 2012 WL 6018890, at *34 (describing how Bauer's position allowed her to profit unfairly at the expense of investors). In its brief, the SEC focused on the timing of Bauer's redemption. *See id.* at 21–24 (recounting Bauer's actions leading up to her redemption). The Commission also alerted the court to the fact that Bauer was a securities lawyer who devised the insider trading policies for HAI. *Id.* at 51. As such, of all of the corporate executives, Bauer should have understood that her conduct could constitute insider trading, and that she should be held to an even higher standard. *Id.*