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Trimming the "Judicial Oak": Rule 10b5-2(b)(1), Confidentiality Agreements, and the Proper Scope of Insider Trading Liability

Ryan M. Davis

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I. INTRODUCTION

In recent years the Securities and Exchange Commission, commonly known as the SEC, has been involved in a number of high-profile suits that have attracted a good deal of media attention. Among those prosecuted by the Commission are hedge fund billionaire and Galleon Group founder Raj Rajaratnam,[1] investment/Ponzi-scheme guru Bernie Madoff,[2] television host and magazine publisher Martha Stewart,[3] and colorful Dallas Mavericks owner Mark Cuban.[4] Although such notable suits may simply be the SEC's attempt to justify its own existence and role in the market it polices in light of the financial disasters of the past decade, these cases do raise some significant questions regarding the amount of power delegated to the Commission by Congress.[5] Specifically, what exactly is the scope of the SEC's authority, and is there any limit on its ability to prosecute some of the most powerful and prominent people in the country?

While the SEC seems to be engaged in some muscle-flexing with regard to whom it chooses to prosecute, the Commission has also attempted to broaden the scope of its statutory power, especially with regard to the doctrine of insider trading.[6] Rule 10b-5—the provision utilized to prosecute inside traders—has experienced expansive growth since its creation, developing from a mere statutory catchall provision in the securities laws to one of the SEC's chief weapons in combating insider trading and other fraudulent actions in the securities markets.[7] In fact, the liberal expansion of Rule 10b-5 from its humble beginnings has been so vast that it led Chief Justice

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1. Press Release, SEC, SEC Charges Billionaire Hedge Fund Manager Raj Rajaratnam with Insider Trading (Oct. 16, 2009), http://www.sec.gov/news/press/2009/2009-221.htm.

2. Press Release, SEC, SEC Charges Bernard L. Madoff for Multi-Billion Dollar Ponzi Scheme (Dec. 11, 2008), http://www.sec.gov/news/press/2008/2008-293.htm.

3. Press Release, SEC, SEC Charges Martha Stewart, Broker Peter Bacanovic with Illegal Insider Trading (June 4, 2003), http://www.sec.gov/news/press/2003-69.htm.

4. Press Release, SEC, SEC Files Insider Trading Charges Against Mark Cuban (Nov. 7, 2008), http://www.sec.gov/news/press/2008/2008-273.htm.

5. *The Securities and Exchange Commission: Growing Insecurities*, ECONOMIST, Jan. 17, 2009, at 37.

6. *See* Thomas O. Gorman, *Appealing Cuban: Aggressive Insider Trading Enforcement*, SEC ACTIONS (Oct. 8, 2009, 5:31 AM), http://www.secactions.com/?p=1570 (stating that the SEC's decision to appeal the district court's ruling in *Cuban* "clearly demonstrates the Commission's willingness to push the edge of insider trading . . . . [T]he SEC is pushing the edge of the required legal obligation toward a parity of information standard").

7. 17 C.F.R. § 240.10b-5 (2010); *see also* Eric C. Chaffee, *Standing Under Section 10(b) and Rule 10b-5: The Continued Validity of the Forced Seller Exception to the Purchaser-Seller Requirement*, 11 U. PA. J. BUS. L. 843, 843–44 (2009) (explaining that Rule 10b-5 was promulgated pursuant to the "catchall" anti-fraud provision of § 10(b) and has since become a powerful tool in combating security fraud).

Rehnquist to remark that the Rule is "a judicial oak which has grown from little more than a legislative acorn."[8]

Despite the significant growth that Rule 10b-5 has undergone since its enactment, the Supreme Court has always carefully limited the Rule to its statutory roots of prohibiting deceptive and manipulative conduct in the securities markets.[9] Traditionally, to be liable for insider trading, the trader had to owe a fiduciary duty to the counterparty to the trade, or have a similar relationship of trust and confidence with him.[10] In the late 1990s, the Court adopted an exception to this general rule known as the misappropriation theory.[11] Under this theory, the scope of liability extends beyond those who owe a duty to the other transacting party to those who owe a duty *only* to the source of the information. Although the misappropriation theory recognizes liability where it did not previously exist, the theory is consistent with the statutory roots of Rule 10b-5 because self-dealing in confidential information, in breach of a duty owed to the source of the information, is clearly deceptive conduct.[12]

This statutory constraint requiring deception on the part of the trader is critical, and is conspicuously absent in the Commission's recent adoption of Rule 10b5-2(b)(1).[13] This bold rule extends liability beyond fiduciary-like relationships to those who owe nothing more than a duty of confidentiality to the source of the information.[14] Although the SEC promulgated Rule 10b5-2(b)(1) in 2000 to clarify the duty requirement of the misappropriation theory, the Rule expands liability well beyond what the theory allows because trading on information one merely has a duty to keep in confidence is not deceptive conduct.[15] This expansion of the insider trading doctrine's scope thus begs the question: Has the Rule caused 10b-5 to outgrow its statutory roots? And, if it has, what rule would best serve the interests

8. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).

9. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472–73 (1977).

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

11. *See* United States v. O'Hagan, 521 U.S. 642, 655 (1997) (adopting the misappropriation theory of insider trading).

12. *See id.* at 653–54 (explaining that the misappropriation theory satisfies § 10(b)'s requirement of deceptive conduct because a fiduciary who feigns loyalty while converting confidential information for personal gain defrauds the principle).

13. 17 C.F.R. § 240.10b5-2(b)(1) (2010).

14. *Id.* ("[A] 'duty of trust or confidence' exists . . . [w]henever a person agrees to maintain information in confidence.").

15. *See* Rebecca S. Smith, Note, O'Hagan *Revisited: Should a Fiduciary Duty Be Required Under the Misappropriation Theory?*, 22 GA. ST. U. L. REV. 1005, 1020 (2006) (explaining that Rule 10b5-2(b)(1) was adopted in response to numerous pleas for clarity regarding the misappropriation theory's duty requirement).

of the securities markets while adhering to 10b-5's statutory limits restricting it to deceptive behavior?

This Note attempts to answer these questions by addressing whether insider trading liability may be extended to those who trade on nonpublic information while subject only to a confidentiality agreement. Part II outlines the background of the insider trading doctrine and the misappropriation theory. Part III analyzes whether one who trades on information he has a duty to keep in confidence is subject to insider trading liability, finding that such a duty is insufficient for liability and that Rule 10b5-2(b)(1) is therefore invalid. However, the loss of Rule 10b5-2(b)(1) would generate confusion and stifle the disclosure of information to parties lacking fiduciary duties when such disclosure is beneficial or necessary for the management of the company. To resolve the gap the annulment of Rule 10b5-2(b)(1) would create, Part IV recommends that liability be limited to those who hold a fiduciary duty or have agreed to refrain from self-dealing in the confidential information.

II. THE MISAPPROPRIATION THEORY: ORIGINS AND DESTINATION

While the history of the misappropriation theory reveals a tendency on the part of both the SEC and the judiciary to expand the reach of insider trading liability, it also establishes that the Supreme Court has always anchored liability to the breach of a specific type of duty. These aspects of the insider trading doctrine's development demonstrate that the Supreme Court is willing to expand the doctrine to fulfill the purposes of the securities laws, but only to a certain point. As this Part will discuss, the Court has *not* extended insider trading liability beyond the breach of a duty to refrain from self-dealing in the confidential information.

A. Rule 10b-5 and Its Limitations

Like many financial regulations, the prohibition against insider trading finds its origins in the increased federal involvement resulting from the stock market crash of October 1929.[16] The 73rd Congress enacted the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act") to curb the widespread abuse reported in the purchase and sale of securities and

16. Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit, 547 U.S. 71, 78 (2006); STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: THE ESSENTIALS 18–19 (2008).

to maintain fair and honest markets.[17] While the Securities Act is mostly concerned with primary market transactions between the issuing corporation and investors, the Exchange Act deals chiefly with secondary market transactions between two investors.[18] One of the principle aims of the Exchange Act was to protect investors and promote public confidence in the securities markets by prohibiting fraud and enacting disclosure requirements.[19] In furtherance of this goal, § 10(b) of the Exchange Act specifically prohibits the "use or employ, in connection with the purchase or sale of any security[,] . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe."[20]

Pursuant to the authority granted the SEC under § 10(b), the Commission enacted Rule 10b-5 for the purpose of regulating fraud in the securities markets.[21] The Rule was originally created in 1942 to close a gap in the antifraud provisions of the Securities Act, which only prohibited fraud in the *sale* of securities and not their *purchase*.[22] Although the Rule was only drafted as a gap-filler, it has since become the leading weapon in the control of fraud in the securities markets and, along with § 10(b), one of the primary provisions for prosecuting insider trading.[23] The Rule makes it unlawful to (1) "employ any device, scheme, or artifice to defraud," (2) "make any untrue statement of a material fact or to omit to state a material fact," or (3) engage in an act which operates "as a fraud or deceit upon any person, in connection with the purchase or sale of any security."[24]

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17. *See* 15 U.S.C. § 78b (2008) (explaining the purpose of the Exchange Act); Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 170–71 (1994) (explaining the securities laws were enacted in response to reports of widespread abuse in the securities markets).

18. CHOI & PRITCHARD, *supra* note 16, at 19.

19. Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1238 (1995).

20. 15 U.S.C. § 78j(b) (2008).

21. 17 C.F.R. § 240.10b-5 (2010); Chaffee, *supra* note 7, at 843–44.

22. LARRY D. SODERQUIST & THERESA A. GABALDON, SECURITIES LAW 148 (3d ed. 2007); *see also* Remarks of Milton Freeman, *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967) (explaining the circumstances under which Rule 10b-5 was developed).

23. *See* David M. Brodsky & Daniel J. Kramer, *A Critique of the Misappropriation Theory of Insider Trading*, 20 CARDOZO L. REV. 41, 45 (1998) (noting that "section 10(b) and Rule 10b-5 have become the primary provisions for prosecuting insider trading"); Chaffee, *supra* note 7, at 843–44 (discussing how § 10(b) and Rule 10b-5 "have become powerful tools in fighting securities fraud").

24. 17 C.F.R. § 240.10b-5.

While the power the SEC claims under Rule 10b-5 appears expansive, the Supreme Court has placed restrictions on its scope. In 1977, the Supreme Court held in *Santa Fe Industries, Inc. v. Green* that Rule 10b-5 is limited to (1) deceptive and manipulative devises, and (2) issues that are not traditionally left to state law.[25] The defendant-corporation in *Santa Fe* executed a short-form merger, and the dissatisfied minority shareholders chose to bring a federal claim under Rule 10b-5 rather than pursuing their appraisal rights under state law.[26] The minority shareholders claimed that the corporation had violated Rule 10b-5 by engaging in the merger without any legitimate business purpose and by obtaining a fraudulent appraisal to lull shareholders into selling their stocks at an inadequate price.[27] Looking to the plain meaning of the statute and its legislative history, the Court concluded that § 10(b) only prohibited conduct that involves manipulation or deception.[28] Because the scope of Rule 10b-5 "cannot exceed the power granted the Commission by Congress under § 10(b)," both § 10(b) and Rule 10b-5 are limited to manipulative and deceptive conduct.[29] The Court held that manipulative conduct requires actions "intended to mislead investors by artificially affecting market activity," which were not present in this case.[30] Deceptive conduct generally entails material misstatements or omissions, and neither occurred here because the minority shareholders received full disclosure.[31] As the corporation's conduct was neither manipulative nor deceptive, it fell outside the scope of Rule 10b-5 and § 10(b).[32] Therefore, the minority shareholders had failed to state a cause of action.[33]

The *Santa Fe* Court further stated that by enacting the securities laws Congress did not intend to create a federal cause of action in matters traditionally relegated to state law, such as corporate law.[34] State law had already provided the minority shareholders with a cause of action to recover the lost value of their

25. 430 U.S. 462, 473–74, 478 (1977).

26. *Id.* at 465–68. The Supreme Court had acknowledged that Rule 10b-5 allows for a private cause of action for violations in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976).

27. *Santa Fe*, 430 U.S. at 468.

28. *See id.* at 473 ("The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception.").

29. *Id.* at 472–73 (quoting *Hochfelder*, 425 U.S. at 214).

30. *Id.* at 476.

31. *Id.* at 474–76.

32. *Id.* at 473–74.

33. *Id.*

34. *Id.* at 478–79.

shares through the appraisal process.[35] Because state law had already created a solution for minority shareholders in these types of situations, the Court found it unlikely that Congress intended to provide a similar federal remedy.[36] The Court further believed that extending the securities laws to cover state causes of action would interfere with state corporate law.[37] If Rule 10b-5 could be invoked in situations where a fiduciary treated a shareholder unfairly, then federal courts would be forced to depart from applying state fiduciary principles in favor of a federal fiduciary standard to ensure uniformity.[38] Because there was no clear indication that Congress desired to "federalize the substantial portion of the law of corporations that deals with transactions in securities," the Court was wary of extending federal law to state causes of action.[39] The Court consequently found that § 10(b) and Rule 10b-5 could not be extended to cover these aspects of state law.[40]

Santa Fe therefore restricts § 10(b) and Rule 10b-5 actions to deceptive and manipulative devices and matters that are not traditionally left to state law.[41]

B. The Development of the Classical Insider Trading Doctrine

Balancing the limitations *Santa Fe* placed on § 10(b) and Rule 10b-5 against the Exchange Act's purpose of creating fair and efficient securities markets has proven to be a difficult endeavor.[42] This conflict is especially apparent in the development of the classical insider trading doctrine.[43] As the doctrine has developed, courts have struggled to grant enough power to Rule 10b-5 to effectively control insider trading, yet simultaneously limit the Rule to its statutory requirements of deceptive and manipulative conduct.

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35. *Id.* at 478.

36. *Id.*

37. *Id.* at 479.

38. *Id.* at 477, 479.

39. *Id.* at 479.

40. *Id.* at 480.

41. *Id.* at 478.

42. *See* 15 U.S.C. § 78b (2008) (noting the purpose of the Exchange Act was to maintain fair and efficient markets).

43. *See* Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1613 (1999) (explaining the conflict between *Santa Fe* and the classical theory of insider trading is that *Santa Fe* held Rule 10b-5 did not reach claims that a shareholder was treated unfairly, yet the entire basis of the classical insider trading doctrine is that a shareholder was treated unfairly by a fiduciary).

In 1961, the SEC first concluded that insider trading violated § 10(b) and Rule 10b-5 in *In re Cady, Roberts & Co.*[44] In addressing insider trading, the Commission held that an insider must either disclose the confidential information on which he is trading or abstain from trading when (1) he has a relationship giving him access to information intended for corporate purposes, and (2) it would be inherently unfair for him to use the information to his advantage without disclosing it to the other party.[45] However, as *Cady, Roberts* was an administrative ruling and not a court decision, it was not immediately clear what precedential value the case would have.[46] It was not until the Second Circuit accepted the Commission's holding seven years later in *SEC v. Texas Gulf Sulphur Co.*[47] that the courts officially adopted the insider trading doctrine.[48] Yet in confirming the doctrine, the Second Circuit elected to greatly expand insider trading liability beyond the requirements established by the SEC in *Cady, Roberts*. The court in *Texas Gulf Sulphur* held that to ensure fairness in the market, insider trading must be expanded beyond those having a special relationship with the other transacting party to anyone in possession of material inside information.[49] Essentially, the Second Circuit required *any* person who obtained nonpublic information to disclose the information prior to trading or to refrain from trading altogether, regardless of whether the trader had a duty to refrain from self-dealing in the information. The ruling in *Texas Gulf Sulphur* effectively established a parity-of-information rule for insider trading that required all investors to be on equal footing.[50]

The expanded scope that Rule 10b-5 enjoyed following the *Texas Gulf Sulphur* decision was short-lived. Courts began to realize the problems caused by such a broad proscription,[51] and in 1980, the Supreme Court in *Chiarella v. United States*[52] limited the reach of the Rule, again anchoring it to its statutory origins. The Court held that

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44. 40 S.E.C. 907, 912 (1961); *see also* Margaret V. Sachs, *Harmonizing Civil and Criminal Enforcement of Federal Regulatory Statutes: The Case of the Securities Exchange Act of 1934*, 2001 U. ILL. L. REV. 1025, 1035 n.62 (explaining that *Cady, Roberts* was the first decision to hold insider trading violated § 10(b) and Rule 10b-5).

45. *Cady, Roberts*, 40 S.E.C. at 912.

46. STEPHEN M. BAINBRIDGE, SECURITIES LAW: INSIDER TRADING 42 (2d ed. 2007).

47. 401 F.2d 833 (2d Cir. 1968).

48. *Id.* at 848.

49. *Id.*

50. Jonn R. Beeson, *Rounding the Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory*, 144 U. PA. L. REV. 1077, 1113 (1996).

51. *See id.* at 1114 (arguing an over-inclusive duty to disclose would deter the free flow of information).

52. 445 U.S. 222 (1980).

because § 10(b) only prohibits fraud based on nondisclosure, a trader cannot be liable for insider trading unless he commits fraud by failing to disclose the nonpublic information to the other party in light of a duty to do so.[53] Vincent Chiarella was a printer by trade and worked for a company that printed announcements for corporate takeover bids.[54] Although documents related to the takeover bids had the identities of the acquiring and target corporations concealed by blank spaces or false names (which were later replaced by the true names the night before printing), Chiarella was able to deduce the identities of the companies before the final printing.[55] Chiarella traded on this confidential information without disclosing it to the other party for a profit of $30,000.[56] The SEC claimed that Chiarella's actions amounted to insider trading in violation of § 10(b) of the Exchange Act along with Rule 10b-5, and he was convicted on all counts.[57]

The Supreme Court reversed Chiarella's conviction, holding that mere possession of material, nonpublic information is an insufficient basis for insider trading liability under § 10(b) absent an affirmative duty to disclose the information.[58] In doing so, the Court rejected the Second Circuit's parity-of-information rule from *Texas Gulf Sulphur* and explained that a *general* duty to disclose information or abstain from trading does not exist.[59] The Court reasoned that although § 10(b) is a catchall provision, what it catches must be considered fraud.[60] Further, when the alleged fraud is "based upon nondisclosure, there can be no fraud absent a duty to speak."[61] The failure to disclose, therefore, can only be considered fraudulent if the trader has a *specific* duty to disclose the information.[62] Because a trader merely in possession of nonpublic information has no specific duty to disclose the information, there is no fraud—and consequently no liability under § 10(b)—if he uses the information for trading purposes.[63] Regarding the requisite duty, the Court held that "the

53. *Id.* at 234–35.

54. *Id.* at 224.

55. *Id.*

56. *Id.*

57. *Id.* at 225.

58. *Id.* at 235–36.

59. *Id.* at 233.

60. *Id.* at 234–35.

61. *Id.* The Second Circuit has recently held that the duty requirement established in *Chiarella* is limited to insider trading allegations based on omissions and does not extend to those based on material misrepresentations. SEC v. Dorozhko, 574 F.3d 42, 48–50 (2d Cir. 2009).

62. *Chiarella*, 445 U.S. at 233.

63. *See id.* at 231 ("Petitioner's use of [the confidential] information was not a fraud under § 10(b) unless he was subject to an affirmative duty to disclose it before trading.").

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.' "[64] *Chiarella* thus establishes that absent a fiduciary duty or similar relationship of trust and confidence, a person in possession of confidential information cannot be liable for insider trading.[65]

Although *Chiarella* redirected the evolution of the classical insider trading doctrine back toward its statutory underpinnings, where liability is rooted in fraud through nondisclosure, the decision left many holes in the insider trading doctrine that needed to be filled.[66] Because *Chiarella* required a special relationship between the trader and the other transacting party, a significant gap was created in which traders who obtained confidential information but were not fiduciaries of the company or its shareholders were exempt from the prohibition altogether.[67] To resolve this problem, the Court adopted the misappropriation theory of insider trading.[68]

C. Expansion of Insider Trading: Acceptance of the Misappropriation Theory

The misappropriation theory expanded the insider trading doctrine by allowing for liability when *Chiarella*'s requisite duty is owed to the trader's source of the information, even when the trader owes no duty to the other transacting party.[69] The misappropriation theory arose out of Chief Justice Burger's dissent in *Chiarella*,[70] in which he claimed that Chiarella committed fraud by misappropriating valuable, confidential information that was entrusted to him by the offeror corporation.[71] Such a fraudulent act, Burger argued, would clearly violate § 10(b) and Rule 10b-5 and therefore Chiarella should

64. *Id.* at 228 n.9 (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)).

65. *Id.* at 229.

66. *See* BAINBRIDGE, *supra* note 46, at 98–99 (noting the significant gaps in the law of insider trading following the *Chiarella* decision).

67. *See id.* (providing an example of what the insider trading doctrine failed to cover following *Chiarella*).

68. *Id.* at 50.

69. United States v. O'Hagan, 521 U.S. 642, 652 (1997) (explaining the misappropriation theory).

70. Nathan Heyde, Note, *Can You Keep a Secret? The "Similar Relationship of Trust and Confidence" in Misappropriation Theory:* U.S. v. Kim, 26 WHITTIER L. REV. 653, 667 (2004).

71. Chiarella v. United States, 445 U.S. 222, 245 (1980) (Burger, J., dissenting); *see also id.* at 240 ("I would read § 10(b) and Rule 10b-5 to encompass and build on this principle: to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading.").

have been held liable for insider trading.[72] Though the misappropriation theory had its roots in the *Chiarella* decision, it took nearly twenty years for the Supreme Court to officially accept the doctrine.[73]

In *Dirks v. SEC*,[74] the Supreme Court took the first step toward accepting the misappropriation theory by extending the reach of § 10(b) liability beyond those who have a fiduciary-like relationship with the other transacting party.[75] The defendant, Raymond Dirks, was an investment analyst who learned from a former officer of Equity Funding of America that the company was fraudulently overvaluing its assets.[76] After researching the matter and confirming that Equity Funding was engaged in fraud, Dirks spread word throughout the market, causing the company's stock price to plummet and forcing Equity Funding into receivership.[77] The SEC later discovered that before the information had become formally known to the public, Dirks had advised clients to sell their stock in the corporation.[78] Rather than rewarding Dirks, the Commission accused him of aiding and abetting violations of the securities laws, including § 10(b) and Rule 10b-5, but only censured him due to his role in uncovering Equity Funding's massive fraud.[79] Dirks sought review by the Supreme Court and the ruling was reversed.[80]

In reversing the SEC's ruling, the Court reaffirmed its holding in *Chiarella* that possession of confidential information, absent a duty to the other party to disclose, is not enough to trigger liability under Rule 10b-5 or § 10(b) for insider trading.[81] However, the Court also recognized that a ban on some "tippee" trading is necessary. It held:

> [A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information *only* when the insider has breached his fiduciary duty to

72. *Id.* at 245.

73. *Chiarella* was decided in 1980 and the doctrine was finally accepted by the Supreme Court in 1997 in *United States v. O'Hagan*, 521 U.S. 642 (1997).

74. 463 U.S. 646 (1983).

75. *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, 372–73 (noting that because of the *Dirks* decision, "the courts developed a concept of a temporary or constructive fiduciary").

76. *Dirks*, 463 U.S. at 648–49.

77. *Id.* at 650.

78. *Id.* at 650–51.

79. *Id.* at 650–52.

80. *Id.* at 652.

81. *Id.* at 657–58.

> the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.[82]

According to the Court, an insider who provides confidential information to another party breaches his fiduciary duty when the insider will "benefit, directly or indirectly, from his disclosure."[83] In essence, because the insider breached a duty to refrain from personally benefitting from the confidential information, the tippee becomes a "temporary or constructive fiduciary" of the trading party and can therefore be liable for insider trading.[84] Because Dirks had no pre-existing fiduciary duty to Equity Funding shareholders and the insider who passed along the information obtained no personal benefit by notifying Dirks of the fraud, Dirks could not be liable for insider trading and thus the SEC's ruling was reversed.[85]

By extending liability for insider trading beyond circumstances in which the trader owes a fiduciary duty to the trading party, the Court in *Dirks* took a significant step toward the adoption of the misappropriation theory of insider trading. While the *Dirks* Court maintained that the breach of a fiduciary-like duty owed to the shareholders was necessary, it revealed the Court's willingness to expand the duty requirement to meet desirable policy outcomes.[86] However, following the *Chiarella* and *Dirks* decisions, confusion still lingered as to whether the misappropriation theory was an acceptable basis of liability, and circuits began to split over the issue. While the Fourth and Eighth Circuits rejected the misappropriation theory, the Second, Seventh, and Ninth Circuits accepted it.[87] The Supreme Court ultimately saw the need to resolve the issue and did so in 1997 in *United States v. O'Hagan*.[88]

In *O'Hagan*, the Court formally adopted the misappropriation theory of insider trading liability and again revealed its flexibility

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82. *Id.* at 659–60 (emphasis added). Tippees are those who owe no fiduciary duties to the corporation or its shareholders and have been given confidential information, usually by an insider. *Id.* at 655.

83. *Id.* at 662.

84. Kamman & Hood, *supra* note 75, at 372–73; *see also* Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1338 (2009) (describing the duty imposed by *Dirks* as a fictional fiduciary duty).

85. *Dirks*, 463 U.S. at 665–67.

86. Nagy, *supra* note 84, at 1338.

87. United States v. O'Hagan, 521 U.S. 642, 649–50 & n.3 (1997).

88. 521 U.S. 642 (1997). While the Supreme Court took up the misappropriation theory in *Carpenter v. United States*, 484 U.S. 19 (1987), the Court split 4–4 and therefore affirmed the lower court ruling without issuing an opinion. BAINBRIDGE, *supra* note 46, at 102.

with respect to the duty requirement.[89] James O'Hagan was a partner in a law firm that was aiding Grand Metropolitan in a tender offer to acquire the Pillsbury Company.[90] While O'Hagan did not work on the representation, he obtained information regarding the acquisition and began to purchase call options for Pillsbury stock.[91] When the tender offer was announced, O'Hagan sold his call options for an astounding profit of more than $4.3 million.[92] The SEC took notice and charged O'Hagan with securities fraud in violation of § 10(b) and Rule 10b-5.[93] O'Hagan was eventually convicted and sentenced to a 41-month term of imprisonment.[94] The Eighth Circuit, however, rejected the misappropriation theory of liability and reversed his conviction.[95]

The Supreme Court in turn reversed the Eighth Circuit's decision and formally held that the misappropriation theory may be the basis of liability under § 10(b) and Rule 10b-5.[96] The Court reasoned that nowhere in § 10(b) does it state that the required fraudulent nondisclosure must be based on a breached duty owed to the counterparty in the transaction; instead, "§ 10(b) refers to 'the purchase or sale of any security,' not to identifiable purchasers or sellers of securities."[97] Therefore, the Court held that while a duty to not disclose the information is still necessary to find liability, the requisite duty need not be owed to the other party in the transaction, but rather can be owed to the source of the information.[98]

The *O'Hagan* Court further reaffirmed the holding in *Santa Fe* that § 10(b) required "chargeable conduct [to] involve a 'deceptive device or contrivance' used 'in connection with' the purchase or sale of securities."[99] The conduct alleged under the misappropriation theory satisfies these fraudulent and deceptive elements because the misappropriator is, in essence, "feigning fidelity" to the source of the information while misappropriating the information for his own personal benefit.[100] The Court found that because O'Hagan's pretended loyalty to his employer was fraudulent and deceptive, the

89. *See* Nagy, *supra* note 84, at 1339 (claiming *O'Hagan* "painted fiduciary principles with an extremely broad brush").

90. *O'Hagan*, 521 U.S. at 647.

91. *Id.* at 647–48.

92. *Id.* at 648.

93. *Id.* at 648–49.

94. *Id.* at 649.

95. *Id.*

96. *Id.* at 650.

97. *Id.* at 660.

98. *Id.*

99. *Id.* at 653.

100. *Id.* at 655–56.

requirements of § 10(b) were satisfied.[101] Finally, the Court found that O'Hagan's conduct was "in connection with" a securities transaction because his fraud was consummated when he traded on the information without disclosing to his principal his intent to trade.[102]

There are two additional points to note about the Court's decision in *O'Hagan*. The first is the critical role deception plays in conduct that is prohibited under § 10(b).[103] According to the Court, nondisclosure to the source of the information would not have produced liability under § 10(b) if it was done without deception.[104] This means that absent some other deceptive act, had O'Hagan merely revealed to his source (his employer) that he intended to trade on the information, Rule 10b-5 would not have been violated and he could not have been held liable for insider trading.[105] Liability under the misappropriation theory, therefore, completely turns on the deceptive breach of a duty the trader owes to the source of the information.[106]

The second point to note in *O'Hagan* is that the Supreme Court was once again willing to expand the reach of the insider trading doctrine.[107] While the Court in *Chiarella* held that the trader must owe a duty to the other transacting party to be liable, this was extended in *Dirks* so that even one who does not have the requisite fiduciary-like relationship could inherit it if the tipper breaches a duty to his own benefit.[108] The Court in *O'Hagan* again expanded liability by permitting § 10(b) to serve as the basis of liability for insider trading when the trader breaches a duty owed not to the other trading party, but merely to the source of the information.[109] This is true even though the only harm the source suffers in this situation is the loss of its exclusive use of the information.[110] The Supreme Court's expansion of the doctrine in *O'Hagan* and *Dirks* reveals that the Court is willing

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101. *Id.*

102. *Id.*

103. *See id.* at 654 ("Deception through nondisclosure is central to the theory of liability for [the misappropriation theory].").

104. *Id.* at 655.

105. BAINBRIDGE, *supra* note 46, at 116; *see also* Nagy, *supra* note 84, at 1339 (discussing how *O'Hagan* essentially creates a safe harbor provision, allowing misappropriators to avoid insider trading liability by simply disclosing their intent to trade).

106. *O'Hagan*, 521 U.S. at 655.

107. *See* Jonathan R. Macey, *Securities Trading: A Contractual Perspective*, 50 CASE W. RES. L. REV. 269, 287 (1999) (noting the decision in *O'Hagan* extends the principles advanced in *Chiarella*).

108. Nagy, *supra* note 84, at 1338.

109. *O'Hagan*, 521 U.S. at 650–52.

110. *Id.* at 652.

to stretch the fiduciary duty requirement if necessary to obtain advantageous policy results.[111]

D. Rule 10b5-2(b)(1) and Confidentiality Agreements

Encouraged by the Court's expansion of liability in *O'Hagan*, the Commission promulgated Rule 10b5-2(b)(1) in one of its boldest attempts to extend the scope of insider trading liability beyond fiduciary-like relationships to duties of confidentiality.[112] The Rule was adopted in a direct attempt to restrict the holding of a 1991 Second Circuit case the SEC strongly disagreed with: *United States v. Chestman*.[113] *Chestman* was the first significant court opinion to define which types of relationships outside of the traditional fiduciary duties are sufficient bases for insider trading liability, and it remains the leading decision on the matter.[114]

The facts of the *Chestman* decision "read as if they were lifted out of an exaggerated law school exam."[115] Ira Waldbaum was the president and controlling shareholder of Waldbaum, Inc. ("Waldbaum"), a large supermarket chain.[116] Ira decided to sell Waldbaum for $50 a share and conveyed this information to his sister, Shirley Waldbaum, who told her daughter, Susan Loeb.[117] Susan then relayed the information to her husband, Keith Loeb, who revealed it to his stockbroker, Robert Chestman.[118] Each person in the chain was told to keep the information confidential.[119] Chestman subsequently bought stock in Waldbaum based on this information and the SEC brought charges against him for violating Rule 10b-5 under the

111. *See* Nagy, *supra* note 84, at 1339–40 ("*Chiarella*, *Dirks*, and *O'Hagan* evidence a Supreme Court willing to stretch fiduciary principles to no small degree, when doing so facilitates a desirable policy outcome.").

112. Robert Steinbuch, *Mere Thieves*, 67 MD. L. REV. 570, 596 (2008).

113. 947 F.2d 551 (2d Cir. 1991); *see also* Kamman & Hood, *supra* note 75, at 387–88 (explaining that the SEC extended insider trading to duties of confidentiality through Rule 10b5-2(b)(1) in an attempt to reverse the ruling in *Chestman*); Steinbuch, *supra* note 112, at 596 (stating the SEC "promulgated Rule 10b5-2 in response to limitations on the misappropriation theory suggested in *Chestman*").

114. BAINBRIDGE, *supra* note 46, at 79–80 (noting *Chestman* is the best guidance to date for determining the sufficiency of nontraditional relationships).

115. Keith Valory, Comment, *The Misappropriation Theory of Insider Trading: What Constitutes a "Similar Relationship of Trust and Confidence?"*, 39 SANTA CLARA L. REV. 287, 297 (1998) (quoting David A. Lipton, *Insider Trading with Impunity*, N.Y. TIMES, Oct. 27, 1991, at F13).

116. *Chestman*, 947 F.2d at 555.

117. *Id.*

118. *Id.*

119. *Id.*

misappropriation theory, which had already been adopted in the Second Circuit at the time.[120] The government argued that Keith Loeb owed a fiduciary duty to his wife, Susan, which he breached by disclosing the information regarding the sale of Waldbaum to Chestman.[121] The trial court found Chestman guilty on all counts.[122]

In reversing the lower court's decision,[123] the Second Circuit defined which types of relationships beyond traditional fiduciary duties could lead to insider trading liability.[124] The court first found that neither unilaterally entrusting another with confidential information nor a familial relationship alone is enough to create a fiduciary duty.[125] However, the court noted that under *Chiarella*, either a fiduciary duty *or* a similar relationship of trust and confidence could be sufficient for liability.[126] The phrase "similar relationship of trust and confidence" allowed the court to look beyond the traditional "hornbook fiduciary relations" to other nontraditional relationships to serve as the basis of liability.[127] Therefore, even if Keith Loeb lacked a traditional fiduciary duty to his wife, if the relationship could be deemed a "similar relationship of trust and confidence," it could satisfy *Chiarella*'s duty requirement.[128]

The Second Circuit concluded that only relationships that had comparable characteristics to a fiduciary relationship—namely discretionary authority and dependency—could be considered a "similar relationship of trust and confidence."[129] In doing so, the court intentionally chose to be cautious in extending the misappropriation theory to new relationships to avoid federalizing more state law than was absolutely necessary, thereby heeding the Supreme Court's warning in *Santa Fe*.[130] Because Keith Loeb did not owe his wife Susan a fiduciary duty, and because marital relationships lack the essential characteristics of a fiduciary relationship and thus cannot be

120. *Id.* at 566.

121. *Id.* at 570.

122. *Id.* at 555–56.

123. *Id.* at 554.

124. BAINBRIDGE, *supra* note 46, at 81.

125. *Chestman*, 947 F.2d at 567–68.

126. *Id.* at 556, 564–65.

127. The Court found traditional "hornbook fiduciary relations" to be those "between attorney and client, executor and heir, guardian and ward, principal and agent, trustee and trust beneficiary, and senior corporate official and shareholder." *Id.* at 568.

128. *Id.*

129. *Id.* at 567–69.

130. *Id.* at 567.

considered a "similar relationship of trust and confidence," the Second Circuit reversed Chestman's conviction.[131]

The SEC, however, disagreed with the result in *Chestman*. This disagreement, combined with the weight courts gave to the *Chestman* opinion, prompted the Commission to adopt a broad definition of which types of relationships are sufficient for liability.[132] In particular, the SEC promulgated Rule 10b5-2(b)(1) to clarify the duties upon which liability may rest under § 10(b) and Rule 10b-5.[133] While the SEC was chiefly concerned with the effect *Chestman* would have on information shared in familial and personal relationships, the Commission also took the opportunity to clarify what it saw as the existing law regarding confidentiality agreements.[134] Rule 10b5-2(b)(1) states that although the duty requirement can be satisfied in numerous ways, the requisite " 'duty of trust or confidence' exists . . . [w]henever a person agrees to maintain information in confidence."[135] Although the Commission enacted Rule 10b5-2(b)(1) to reflect the common-sense concept that the necessary duty can arise through agreement between the parties, the wording of the Rule has significant implications as to the limits of insider trading liability.[136] Essentially, the Rule extends liability under § 10(b) and Rule 10b-5 to those who trade on information they agreed to keep confidential, regardless of whether the trader has any fiduciary-like relationship with the informer.

By liberally interpreting the phrase "relationship of trust and confidence" through Rule 10b5-2(b)(1), the SEC essentially dispensed with the duty element of insider trading established by the Court in *Chiarella* and *O'Hagan*, thereby significantly expanding liability under the misappropriation theory.[137] Though the Commission claimed that by enacting Rule 10b5-2(b)(1) it did not intend to modify the scope of the judicially created insider trading law, an analysis of

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131. *Id.* at 571.

132. Nagy, *supra* note 84, at 1357–59 (noting that courts turned to *Chestman* for guidance in determining which duties are considered a "similar relationship of trust and confidence" and that the SEC responded to *Chestman*'s narrow view by enacting Rule 10b5-2(b)(1)).

133. Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,603 (Dec. 28, 1999) (to be codified at 17 C.F.R. pts. 230, 240, 243, & 249).

134. *Id.* at 72,602–03.

135. 17 C.F.R. § 240.10b5-2(b)(1) (2010).

136. *See* Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,603 (explaining that the Rule "reflects the common-sense notion . . . that reasonable expectations of confidentiality, and corresponding duties, can be created by an agreement between two parties").

137. *See* Nagy, *supra* note 84, at 1361 (stating the Rule dispenses with the "relational elements of trust and loyalty essential to *O'Hagan*'s reasoning").

the Rule itself reveals otherwise.[138] While the Supreme Court in *Chiarella* and *O'Hagan* required a relationship of trust *and* confidence in the absence of a fiduciary duty,[139] Rule 10b5-2(b) claims that liability may be based on duties of trust *or* confidence.[140] By changing the "and" in *Chiarella* and *O'Hagan* to "or," the Rule severs the trust aspect from the confidence aspect and declares that either duty alone is sufficient for insider trading liability. Indeed, this modification is further evidenced by Rule 10b5-2(b)(1), which establishes that a duty of confidentiality alone satisfies the duty requirement.[141] This significant alteration raises the question as to whether the SEC's expansion of the doctrine and the Rule itself are valid. The answer to this difficult issue turns on how far the phrase "relationship of trust and confidence" can and should be extended.

This Note will now examine whether a duty of confidentiality alone is enough to establish insider trading liability. It finds that liability cannot be based on confidentiality agreements alone, for although the Supreme Court has been willing to stretch the duty requirement in the past, the Court has always required more than a duty to keep information in confidence. Further, as seen in *Santa Fe* and *O'Hagan*, the Court has continually maintained that the central element in § 10(b) and Rule 10b-5 violations is fraud through nondisclosure, which is absent in circumstances where the trader is only bound by a duty of confidentiality.[142] For these reasons, and as this Note discusses in Part IV, the best solution to this problem is to extend insider trading liability to those who have a duty to refrain from self-dealing in the information, but not so far as to cover those who have a duty of confidentiality alone.

Before reaching this solution, this Note first analyzes the rulings of various lower courts regarding the validity of Rule 10b5-

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138. *See* Selective Disclosure and Insider Trading, 64 Fed. Reg. at 72,603 ("[T]his Rule is not intended to address or modify the scope of insider trading law in any other respect.").

139. *See* United States v. O'Hagan, 521 U.S. 642, 651–53 (1997) (adopting the "relationship of trust and confidence" requirement of *Chiarella* into the misappropriation theory); Chiarella v. United States, 445 U.S. 222, 228 (1980) (requiring that the trader hold a relationship of trust and confidence to be liable for insider trading).

140. *See* 17 C.F.R. § 240.10b5-2 (explaining in the preliminary note that "[t]his section provides a non-exclusive definition of circumstances in which a person has a duty of trust *or* confidence for purposes of the 'misappropriation' theory of insider trading under Section 10(b) of the Act and Rule 10b-5") (emphasis added); *see also* Brief for Allen Ferrell et al. as Amici Curiae Supporting Defendant, SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009) (Civil Action No. 3:08-CV-2050-D) ("The SEC's use of the phrase 'trust *or* confidence' in Rule 10b5-2(b)(1), as opposed to the *O'Hagan* standard of 'trust *and* confidence,' suggests that the SEC sought to go beyond the *O'Hagan* articulation of the misappropriation theory.").

141. 17 C.F.R. § 240.10b5-2(b)(1).

142. *See supra* notes 28–32, 103–106 and accompanying text.

2(b)(1) and whether a duty of confidentiality on its own can establish insider trading liability.

III. DIFFERING VIEWS OF A "SIMILAR RELATIONSHIP OF TRUST AND CONFIDENCE" AND THE VALIDITY OF RULE 10b5-2(b)(1)

A. Where the Courts Stand on the Issue

Because the duty requirement of insider trading was established by the courts,[143] we must first turn to the courts to determine its scope and whether a duty of confidentiality suffices. Although the question has great implications on the reach of the insider trading doctrine, the scope of the phrase "similar relationship of trust and confidence" has never been considered by the Supreme Court. The Second Circuit's opinion in *Chestman* consequently remains the most influential source on the matter.[144] However, several courts at both the appellate and district levels have analyzed the issue, and while some have held that the phrase permits confidentiality agreements to serve as the basis of liability, others have rejected such a broad view.

1. Cases Supporting a Broad View of the Duty Requirement

Some of the most notable decisions supporting a more liberal reading of the duty requirement are *United States v. Falcone*,[145] *SEC v. Yun*,[146] and *SEC v. Northern*.[147] *Falcone* was decided by the Second Circuit in 2001, and although the facts of the case involve a tipper-tippee scenario rather than one in which a duty of confidentiality was breached, the opinion suggests that a confidentiality agreement alone *can* subject one to insider trading liability.[148] In *Falcone*, then-Judge

143. *See Chiarella*, 445 U.S. at 224 (establishing the duty requirement); *see also supra* notes 51–65 and accompanying text.

144. *See* Nagy, *supra* note 84, at 1357–59 (noting that courts often look to *Chestman* for guidance in determining which duties are considered a "similar relationship of trust and confidence").

145. 257 F.3d 226 (2d Cir. 2001).

146. 327 F.3d 1263 (11th Cir. 2003).

147. 598 F. Supp. 2d 167 (D. Mass. 2009). For less influential cases which suggest that a duty of confidentiality is sufficient to establish insider trading liability, see *SEC v. Lyon*, 529 F. Supp. 2d 444, 451 (S.D.N.Y. 2008), *SEC v. Talbot*, 430 F. Supp. 2d 1029, 1055 (C.D. Cal. 2006), *rev'd* on other grounds, 530 F.3d 1085 (9th Cir. 2008), and *SEC v. Kirch*, 263 F. Supp. 2d 1144, 1150–51 (N.D. Ill. 2003).

148. *See Falcone*, 257 F.3d at 227–28, 234 (holding that "a fiduciary relationship, or its functional equivalent, exists only where there is explicit acceptance of a duty of confidentiality or

Sotomayor, writing for the court, found that the functional equivalent of a fiduciary relationship exists where either the trading party accepts a duty of confidentiality or such acceptance can be implied from the relationship between the parties.[149] In reaching this conclusion, the Second Circuit interpreted *Chestman* as only requiring a fiduciary duty or similar relationship of trust and confidence when the trader lacks an express duty of confidentiality.[150] This interpretation of *Chestman* is interesting, considering it directly conflicts with the bulk of the opinion. In *Chestman*, the court took great pains in establishing that absent a fiduciary relationship, a trader may *only* be liable if he has a duty with the same characteristics of a fiduciary duty.[151] Furthermore, the *Chestman* court applied this interpretation of a "similar relationship of trust and confidence" to the confidentiality agreement at issue in the case and found that the duty requirement was not met.[152] Regardless of these inconsistencies, *Falcone* is often cited for the position that an agreement to keep information confidential is sufficient to satisfy the duty requirement for insider trading liability.[153]

Another influential circuit case that supports a broad view of the insider trading doctrine is *SEC v. Yun*, where the Eleventh Circuit held that a confidentiality agreement alone was sufficient to satisfy § 10(b)'s duty requirement.[154] The defendant, Donna Yun, was married to David Yun, the president of Scholastic Book Fairs, Inc.[155] David communicated nonpublic information to Donna regarding an upcoming announcement that would decrease the value of Scholastic's stock, and she agreed to keep the information confidential.[156] Donna

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where such acceptance may be implied from a similar relationship of trust and confidence between the parties").

149. *Id.* at 234.

150. *Id.* at 234–35.

151. United States v. Chestman, 947 F.2d 551, 567–69 (2d Cir. 1991).

152. *Id.* at 571; *see also supra* notes 123–31 and accompanying text.

153. *E.g.*, SEC v. Lyon, 529 F. Supp. 2d 444, 451 (S.D.N.Y. 2008) (relying on *Falcone* to establish that acceptance of a duty of confidentiality satisfies the requisite duty for insider trading); SEC v. Talbot, 430 F. Supp. 2d 1029, 1054–55 (C.D. Cal. 2006), *rev'd* on other grounds, 530 F.3d 1085 (9th Cir. 2008) (relying on *Falcone* and *Yun* to establish that an express agreement to not reveal confidential information meets the duty requirement for insider trading); SEC v. Kornman, 391 F. Supp. 2d 477, 490 (N.D. Tex. 2005) (relying on *Falcone* to support Rule 10b5-2(b)(1)).

154. 327 F.3d 1263, 1273–75 (11th Cir. 2003).

155. *Id.* at 1267.

156. *Id.*

relayed the information to her coworker, Jerry Burch,[157] who traded on the information for a $269,000 profit—a 1,300 percent return on his investment.[158] Both Donna and Burch were found jointly liable for violating Rule 10b-5 and were ordered to disgorge the profits acquired.[159] On appeal, the Eleventh Circuit held that the duty requirement could be satisfied not only by a fiduciary-like relationship, but also by either an express agreement of confidentiality or a showing that the disclosing party had a reasonable expectation that the information would be safeguarded.[160] Although allowing a party's expectations to establish the duty requirement comes dangerously close to conflicting with the Supreme Court's holding in *Chiarella* that mere possession of nonpublic information is insufficient,[161] the court found that Donna's confidentiality agreement, along with her history of keeping David's business information confidential, satisfied the duty element of the misappropriation theory.[162]

The issue was also recently addressed in *SEC v. Northern*, in which the Massachusetts District Court held that a duty to keep information confidential was enough to establish liability and explicitly rejected the defendant's argument that the SEC had exceeded its rulemaking authority in enacting Rule 10b5-2(b)(1).[163] In *Northern*, Peter Davis (a financial consultant) attended a U.S. Department of Treasury press conference where he was given nonpublic information regarding the suspension of 30-year bonds, which he was told to keep confidential until 10:00 a.m. that same day.[164] Before the embargo on the information had expired, Davis passed the information on to Steven Northern (his client) who traded on the information for a multi-million dollar profit.[165] The court found the duty of confidentiality imposed on Davis by the Treasury

157. Although neither party admitted that Donna revealed the information to Burch, Burch told his stockbroker he wanted to purchase the options based on information he learned at a cocktail party the night before, which he attended with Donna. *Id.* at 1268.

158. *Id.*

159. *Id.* at 1270.

160. *Id.* at 1273.

161. Chiarella v. United States, 445 U.S. 222, 235 (1980); *see also infra* notes 217–23 and accompanying text.

162. *Yun*, 327 F.3d at 1273–75. Although both defendants met these requirements, the court reversed the convictions on other grounds. *See id.* at 1281–82 (granting a new trial because the district court only required the SEC to show that Donna Yun had been severely reckless in disclosing the confidential information).

163. 598 F. Supp. 2d 167, 174, 176 (D. Mass. 2009).

164. *Id.* at 170.

165. *Id.*

Department sufficient to establish liability, and consequently denied Northern's motion for summary judgment.[166] In doing so, the court briefly discussed whether Rule 10b5-2(b)(1) was inconsistent with the language of § 10(b) and therefore beyond the scope of the SEC's rulemaking authority, but ultimately rejected this argument without much analysis.[167] The court further remarked: "[I]t appears that the Supreme Court acknowledged that a contract providing a corporate outsider access to confidential information may be sufficient to create a duty from which misappropriation liability may arise," and thus a contractual duty could take the place of the requisite fiduciary-like duty.[168] By denying the defendant's motion for summary judgment, the court gave credence to the view that a confidentiality agreement alone satisfies the duty requirement for insider trading liability.

2. Cases Supporting a Narrow View of the Duty Requirement

While a number of courts have supported the SEC's theory that a duty of confidentiality meets the duty element of insider trading, other courts have specifically addressed and rejected this view. Two cases demonstrating this are *United States v. Kim*[169] and *SEC v. Cuban*.[170]

In *Kim*, a California district court held that a confidentiality agreement failed to satisfy the duty requirement because the obligation was not sufficiently similar to a fiduciary relationship.[171] The defendant, Keith Joon Kim, was a member of an organization of young company presidents in which all members, as a condition of membership, were expected to comply with a written confidentiality agreement and to not discuss anything learned through the organization with others.[172] Kim obtained confidential information from another member and traded on it for a profit of over $200,000.[173] Because Kim's liability was not based on a typical fiduciary duty, the court had to determine whether a duty of confidentiality alone could be considered a "similar relationship of trust and confidence."[174] In

166. *Id.* at 176.

167. *Id.* at 174.

168. *Id.* at 175.

169. 184 F. Supp. 2d 1006 (N.D. Cal. 2002).

170. 634 F. Supp. 2d 713 (N.D. Tex. 2009), *vacated*, No. 09-10996, 2010 WL 3633059 (5th Cir. Sept. 21, 2010).

171. *Kim*, 184 F. Supp. 2d at 1012.

172. *Id.* at 1008.

173. *Id.* at 1008–09.

174. *Id.* at 1010.

making this determination, the court looked to the *Chestman* opinion for the proposition that a "similar relationship of trust and confidence" must have characteristics similar to those of a fiduciary duty.[175]

The court found that because there was no disparate knowledge or expertise, no persuasive need to share confidential information, and no legal duty to render competent aid, a duty of confidentiality alone could not be considered a "similar relationship of trust and confidence."[176] Although the actions in this case occurred before the SEC enacted Rule 10b5-2(b)(1), the court reviewed the Rule and concluded that an express agreement of confidentiality can serve as the basis of liability only if the agreement creates a relationship that has the "hallmarks of a fiduciary relationship."[177] Finally, the court noted that although the members of the organization were bound by an express confidentiality agreement, the agreement could not be the basis of liability because it only appealed to the members' morality and did not give rise to any legal duties.[178] The allegations were therefore dismissed.[179]

In the 2009 high-profile case of *SEC v. Cuban*, a Texas district court took a similar stance on the issue to the court in *Kim*, holding that insider trading liability could not be based on a duty of confidentiality alone.[180] However, the court went even further than the *Kim* court and questioned the validity of Rule 10b5-2(b)(1) itself.[181] Mark Cuban—the well-known owner of the Dallas Mavericks—obtained nonpublic information from the CEO of Mamma.com[182] regarding a planned private investment in public equity offering (more commonly known as a PIPE offering) by the company and agreed to keep the information in confidence.[183] Cuban traded on the information and avoided a loss in excess of $750,000.[184]

The court found that while no fiduciary relationship existed between the CEO of Mamma.com and Cuban, a sufficient duty could arise through agreement.[185] Such an agreement, however, would have

175. *Id.* at 1011–12.

176. *Id.*

177. *Id.* at 1014–15.

178. *Id.* at 1015.

179. *Id.*

180. 634 F. Supp. 2d 713, 725–26 (N.D. Tex. 2009), *vacated*, No. 09-10996, 2010 WL 3633059 (5th Cir. Sept. 21, 2010).

181. *Id.* at 730.

182. Mamma.com is a Canadian based search engine, in which Mark Cuban was the largest known shareholder. *Id.* at 717.

183. *Id.*

184. *Id.* at 718.

185. *Id.* at 725.

to "consist of more than an express or implied promise merely to keep information confidential. It must also impose on the party who receives the information the legal duty to refrain from trading on or otherwise using the information for personal gain."[186] The court's rationale for this was that § 10(b) was intended to prevent deceptive conduct in the securities markets, so if the trader only promises to keep the information confidential and does not promise to refrain from using it for personal gain, there is no deception.[187] Essentially, absent a duty to refrain from using the information for personal benefit, it is not deceptive to do so.[188] Because Cuban did not promise to abstain from using the information to his benefit, his actions were not deceptive and therefore not prohibited by § 10(b).[189]

The *Cuban* court additionally found that Rule 10b5-2(b)(1) could not be relied upon to establish liability because the SEC had exceeded its authority in enacting the regulation.[190] The court reasoned that § 10(b) only enabled the Commission to enact rules prohibiting fraudulent conduct, and because trading on information one is only required to keep confidential is not fraudulent, the SEC lacked the authority to enact the regulation.[191] Because the SEC could not rely on either the confidentiality agreement itself or Rule 10b5-2(b)(1) to provide the basis for insider trading liability, the case was dismissed.[192]

Although the *Cuban* court's ruling was later vacated on appeal because the Fifth Circuit believed there was sufficient evidence to find that Cuban had, in fact, agreed to not use the information for his own benefit, the lower court's opinion continues to strongly support the view that confidentiality agreements are inadequate to establish liability.[193] In overruling the judgment, the Fifth Circuit did not challenge the legal conclusion of the lower court that an agreement to refrain from benefiting from the nonpublic information was necessary for liability. To the contrary, the Fifth Circuit believed that there was at least a plausible basis that Cuban had agreed to not trade on the

186. *Id.*

187. *Id.* at 724–25.

188. *Id.* at 725.

189. *Id.* at 731.

190. *Id.* at 730–31.

191. *Id.*

192. *Id.* at 731. Although the *Cuban* court gave the SEC thirty days to file an amended complaint alleging Cuban had accepted a duty to not use the nonpublic information, the SEC chose not to amend its complaint and the district court thereafter dismissed the action. *Id.* at 731–32.

193. SEC v. Cuban, No. 09-10996, 2010 WL 3633059, at *5 (5th Cir. Sept. 21, 2010).

information, and therefore summary judgment was improper under the lower court's legal standard. Because the Fifth Circuit vacated the ruling on the grounds that summary judgment had been improperly granted, the appellate court declined to address the validity of Rule 10b5-2(b)(1), effectively punting on the issue.

B. Failings of the Broad View: Analysis of Confidentiality Agreements and Rule 10b5-2(b)(1)

As the previous cases reveal, courts have split over the scope of the phrase "similar relationship of trust and confidence." While some have adopted a broad view, extending the phrase to cover confidentiality agreements, others have opted for a much narrower approach, placing such agreements beyond the reach of Rule 10b-5 and the insider trading doctrine. This Note now examines the arguments raised by these cases to determine whether a duty of confidentiality may serve as a sufficient basis for liability and the validity of Rule 10b5-2(b)(1).

It is well established that for the duty element to be satisfied, a fiduciary or similar relationship of trust and confidence must exist.[194] Because a confidentiality agreement alone fails to establish a fiduciary relationship between the parties, to be sufficient such a duty must fall into the second category of relationships: a similar relationship of trust and confidence. There are four reasons drawn from the case law that a duty of confidentiality alone fails to meet the duty element for establishing insider trading liability.

First, confidentiality agreements lack the traditional hallmark characteristics of fiduciary relationships. In *Chestman*, the leading case on similar relationships of trust and confidence, the Second Circuit stated that the term "similar" denotes that the essential characteristics of fiduciary duties must be present.[195] Such characteristics include de facto control and dominance, superiority and influence, and discretionary authority and dependency on the part of the fiduciary.[196] Black's Law Dictionary describes a fiduciary as one who "is required to act for the benefit of another person on all matters within the scope of their relationship."[197] In *Kim*, a federal district court asserted that fiduciary relationships arise out of a combination

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

195. United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991).

196. *Id.* at 568–69.

197. BLACK'S LAW DICTIONARY 658 (8th ed. 2007).

of disparate knowledge and expertise, a persuasive need to share confidential information, and a legal duty to render competent aid.[198]

Under this backdrop, it is difficult to understand how confidentiality agreements can meet this high standard. A duty of confidentiality can be imposed upon any person without any obligation for that person to act for the benefit of the disclosing party. Additionally, there is no need for superiority, dominance, disparate knowledge, or influence on the part of the individual with the duty of confidentiality. Indeed, as can be seen from *Northern*, a duty of confidentiality can be imposed with as little as a statement to the party that the information should be kept confidential, with no other special duty on the bound person.[199] Because confidentiality agreements fail to impose the classical fiduciary characteristics of dominance, control, or a duty to act for the benefit of the other party, such agreements cannot be considered similar to fiduciary duties.

Additionally, while the *Dirks* and *O'Hagan* cases reveal a certain willingness on the part of the Supreme Court to manipulate the duty element to meet the needs of practicality and fairness, the Court's decisions have always been anchored upon a duty to refrain from self-dealing in the inside information. Although the Court agreed in *Dirks* to extend liability to those who were tipped on inside information, such liability could only attach to the tippee if the tipper breached a duty to refrain from benefitting from the confidential information.[200] Similarly, although the Court in *O'Hagan* declared that a duty owed to the source of the information rather than to the counterparty to the trade was sufficient to find insider trading liability, the Court maintained that a duty to not benefit from the information was still required for liability.[201] These cases clearly illustrate that although the Court is willing to extend liability when necessary, the Court has refused to extend liability beyond circumstances in which a duty to refrain from self-dealing has been breached. As a confidentiality agreement itself imposes no duty upon either party to abstain from using the information to his advantage, it is unlikely that the Supreme Court would allow such obligations to serve as the basis of liability.

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198. United States v. Kim, 184 F. Supp. 2d 1006, 1011 (N.D. Cal. 2002).

199. SEC v. Northern, 598 F. Supp. 2d 167, 176 (D. Mass. 2009) (finding that a reasonable jury could conclude a duty of confidentiality was imposed on attendees at a press conference when the U.S. Treasury Department told them to keep the information in confidence).

200. Dirks v. SEC, 463 U.S. 646, 662 (1983).

201. United States v. O'Hagan, 521 U.S. 642, 652–53 (1997) ("[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.").

A second reason insider trading liability should not derive from confidentiality agreements alone is that allowing this outcome would come close to accepting the parity-of-information rule the Court has already rejected. In *Chiarella*, the Supreme Court explicitly stated 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," thereby rejecting the parity-of-information rule accepted in *Texas Gulf Sulphur*.[202] Indeed, the *Chiarella* Court held that "a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information."[203] As a result, it is not enough to merely trade on confidential information; the party must also have a duty to refrain from doing so.[204]

As noted above, it is also exceptionally easy to establish a duty of confidentiality. To do so, a disclosing party need only declare that information should be kept confidential. Allowing a duty—which could result in insider trading liability for the party receiving the information—to be imposed so simply puts a near-moratorium on the use of all confidential information in the securities markets. The only information that could be used without worry of future liability is information obtained without the magic words: "keep it confidential." It would be a strange rule indeed that allows criminal fines, treble damages, and a possible prison sentence to turn on such a phrase.[205]

Third, premising insider trading liability on the breach of a duty of confidentiality would carry liability beyond the bounds of the securities laws. As established in *Santa Fe*, the securities laws do not even cover all breaches of fiduciary duties.[206] Further, as the Supreme Court stated in *Marine Bank v. Weaver* in 1982, "Congress, in enacting the securities laws, did not intend to provide a broad federal remedy

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202. Chiarella v. United States, 445 U.S. 222, 233 (1980); *see also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (adopting a parity-of-information rule).

203. *Chiarella*, 445 U.S. at 235.

204. *See Dirks*, 463 U.S. at 660 ("[S]ome tippees must assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them *improperly*."); United States v. Chestman, 947 F.2d 551, 567 (2d Cir. 1991) ("[A] fiduciary duty cannot be imposed unilaterally by entrusting a person with confidential information.").

205. *See* Insider Trading Sanctions Act of 1984 § 2, 15 U.S.C. § 78u-1(a) (2008) (allowing for treble damages for insider trading violations); Insider Trading and Securities Fraud Enforcement Act of 1988 § 4, 15 U.S.C. § 78ff(a) (2008) (allowing for criminal fines and prison sentences for insider trading violations).

206. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476–77 (1977) (holding a claim of fiduciary breach only states a cause of action under Rule 10b-5 if the alleged conduct is manipulative or deceptive); *see also O'Hagan*, 521 U.S. at 655 (stating *Santa Fe* underscored that "§ 10(b) is not an all-purpose breach of fiduciary duty ban").

for all fraud."[207] The Court reiterated this view as recently as 2008 when it held in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* that "[s]ection 10(b) does not incorporate common-law fraud into federal law."[208] By extending the securities laws to cover breaches of confidentiality agreements, the insider trading doctrine would essentially become a federal remedy for common-law fraud and breach of contract. As confidentiality contracts are typically relegated to state law, expanding the insider trading doctrine to such contracts would conflict with the ruling in *Santa Fe* that such state law issues should be left to state law.[209]

Fourth, one who is subject to a duty of confidentiality and trades on the information has not engaged in the deceptive conduct required by § 10(b), Rule 10b-5, and the Supreme Court. Section 10(b) of the Exchange Act specifically prohibits the use of "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe."[210] In enacting Rule 10b-5 under this provision, the Commission established that among other things, it is unlawful "[t]o 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."[211] In *Santa Fe*, the Supreme Court held that for a claim of fraud under Rule 10b-5 to be sufficient, it must allege conduct that is manipulative or deceptive within the meaning of § 10(b).[212] Further, in the context of insider trading, the Court held in *Chiarella* that although "[s]ection 10(b) is aptly described as a catchall provision . . . what it catches must be fraud."[213] *O'Hagan* clearly affirmed this principle when stating that "[d]eception through nondisclosure is central to [the misappropriation theory]."[214] The bottom line is that clearly no action can be considered a violation of § 10(b) or Rule 10b-5 unless it amounts to fraud.

Trading on information one agrees only to maintain in confidence fails to qualify as deceptive or fraudulent conduct under

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207. 455 U.S. 551, 556 (1982).

208. 552 U.S. 148, 162 (2008).

209. *See Santa Fe*, 430 U.S. at 478 ("A . . . factor in determining whether Congress intended to create a federal cause of action in these circumstances is 'whether the cause of action (is) one traditionally relegated to state law.' " (quoting Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 40 (1977))).

210. 15 U.S.C. § 78j (2008).

211. 17 C.F.R. § 240.10b-5 (2010).

212. *Santa Fe*, 430 U.S. at 473–74.

213. Chiarella v. United States, 445 U.S. 222, 234–35 (1980).

214. United States v. O'Hagan, 521 U.S. 642, 654 (1997).

§ 10(b) and Rule 10b-5 because no duty is breached in doing so. By promising to keep information confidential, one is not agreeing to refrain from trading on the information or not to use it for personal benefit. Rather, as the *Cuban* court noted, a duty of confidentiality only requires that the information be kept confidential.[215] Therefore, trading on information obtained while under a duty of confidentiality cannot be considered fraudulent or deceptive because the trader has not disclosed the information, and consequently there is no breach. Such an argument mirrors that of the Supreme Court in *O'Hagan*, where it found that the misappropriator's feigned fidelity to the source of the information is central to liability: "if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation."[216] Under both scenarios, if the use of the information is not fraudulent, it cannot be the basis of liability.

Although one can argue that the disclosing party generally has the expectation that a trader under a duty of confidentiality will refrain from using the information to his own benefit, courts have repeatedly found that the mere expectations of a party are insufficient to establish insider trading liability.[217] This principle would ignore the holding in *Chiarella* that liability cannot be imposed absent a *specific* duty to refrain from trading and that such a duty does not arise from the mere possession of confidential information.[218] The Court confirmed that this rule applies under the misappropriation theory in *O'Hagan* by reemphasizing that a specific duty to refrain from using the information is needed for liability and that no general duty exists.[219]

Additionally, as the Second Circuit noted in *Chestman*, this requisite duty "cannot be imposed unilaterally by entrusting a person

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215. SEC v. Cuban, 634 F. Supp. 2d 713, 725–26 (N.D. Tex. 2009), *vacated*, No. 09-10996, 2010 WL 3633059 (5th Cir. Sept. 21, 2010) (finding that an obligation to keep information confidential is separate from a duty to not use the inside information for personal benefit).

216. *O'Hagan*, 521 U.S. at 655.

217. *See, e.g.*, Walton v. Morgan Stanley & Co., 623 F.2d 796, 799 (2d Cir. 1980) (finding that the expectation on the part of the disclosing party that the recipient will refrain from trading on the nonpublic information is insufficient to impose the necessary duty); SEC v. Talbot, 430 F. Supp. 2d 1029, 1060 (C.D. Cal. 2006) (same); SEC v. Ingram, 694 F. Supp. 1437, 1440 (C.D. Cal. 1988) (same). *See also* BAINBRIDGE, *supra* note 46, at 75 (noting that the decision in *Walton* is generally regarded as an accurate statement of the law). This suggests that other portions of Rule 10b5-2 are also invalid, such as Rule 10b5-2(b)(2) which extends insider trading liability to those who have a history or pattern of sharing confidential information. Whether the SEC has also exceeded its authority by enacting Rule 10b5-2(b)(2) is beyond the scope of this Note, which is limited to an analysis of Rule 10b5-2(b)(1) and confidentiality agreements.

218. *Chiarella*, 445 U.S. at 233, 238.

219. *O'Hagan*, 521 U.S. at 661.

with confidential information" because simply disclosing nonpublic information in no way changes the relationship between the parties.[220] Given that a specific duty must exist before a party can be found liable and that the expectations of the disclosing party fail to create any such duty on the part of the recipient, liability cannot be based upon these expectations.

Furthermore, as insider trading can bring with it criminal liability, including prison time, there is a strong argument that relying exclusively on the expectations of the disclosing party as to the extent of the confidentiality agreement would violate the Due Process Clause of the Fifth Amendment.[221] The Supreme Court has repeatedly emphasized that criminal laws that do not provide adequate notice of the criminality of an act violate due process.[222] Permitting liability to be based upon the intentions of the disclosing party would fail to give adequate notice because it requires the trader to divine the intentions of the disclosing party.[223] To provide fair notice, liability must turn on the terms of the agreement itself.

All of these points require the Supreme Court to find that the SEC has exceeded its authority in enacting Rule 10b5-2(b)(1), which prohibits those under confidentiality agreements from trading even though such conduct is not deceptive under § 10(b). When the "judicial oak" that Rule 10b-5 has become outgrows its statutory roots, it must be trimmed. However, revoking the Rule would generate uncertainty in the market as to which types of duties can serve as the basis of insider trading liability. This could deter the disclosure of confidential information to outsiders when doing so would increase efficiency or otherwise benefit the corporation and its shareholders. A new, uniform rule must therefore be adopted to allow for such beneficial disclosure to those who lack a fiduciary or similar duty, yet prevent recipients of the information from trading on it.

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220. United States v. Chestman, 947 F.2d 551, 567–68 (2d Cir. 1991).

221. *See* U.S. CONST. amend. V ("No person shall be . . . deprived of life, liberty, or property, without due process of law . . . ."); *see also* Insider Trading Sanctions Act of 1984 § 2, 15 U.S.C. § 78u-1(a) (2008) (allowing for treble damages for insider trading violations); Insider Trading and Securities Fraud Enforcement Act of 1988 § 4, 15 U.S.C. § 78ff(a) (2008) (allowing for criminal fines and prison sentences for insider trading violations).

222. Jordan v. De George, 341 U.S. 223, 230 (1951) ("This Court has repeatedly stated that criminal statutes which fail to give due notice that an act has been made criminal before it is done are unconstitutional deprivations of due process of law.").

223. Such an interpretation has also been used in the field of tax law. *E.g.*, United States v. Harris, 942 F.2d 1125, 1131–32, 1135 (7th Cir. 1991) (finding a definition of "gift" which would require the donee to divine the intentions of the donor to be unsatisfactory in circumstances where criminal liability is at stake).

IV. FILLING THE VOID CREATED AFTER ABANDONING RULE 10b5-2(b)(1)

In crafting a legal standard to replace Rule 10b5-2(b)(1) and define the duties sufficient to establish insider trading liability, a number of factors must be taken into account. This Part briefly addresses these considerations, and goes on to propose that insider trading liability should be based only on fiduciary duties or express agreements to refrain from self-dealing in confidential information. Lastly, it explains why liability should not be limited only to those who are subject to a fiduciary duty.

A. Solution: Insider Trading Liability Should be Based on Fiduciary Duties and Agreements to Refrain from Self-Dealing

Several considerations must be taken into account in establishing a workable rule to replace Rule 10b-2(b)(1). First and foremost, the breach of the duty relied upon for liability must involve some type of deception or fraud so that it is within the statutory bounds of § 10(b). In order to heed the Supreme Court's warnings in *Santa Fe*, the solution must also not necessitate the federalization of any more state common law than is required. Any viable solution must further comply with the Exchange Act's goals: "to insure honest securities markets and thereby promote investor confidence."[224] Finally, the solution should not create a parity-of-information rule, as such a rule would conflict with the Court's holding in *Chiarella* and may potentially discourage the disclosure of confidential information when doing so would be advantageous to the corporation.

The solution that best satisfies these criteria is to hold that the duty requirement is only satisfied by a fiduciary duty or a duty arising from an express agreement to refrain from using the information for personal gain. Such a solution is similar to the rule adopted by the court in *Cuban*[225] and should be accepted as the basis of insider

224. *O'Hagan*, 521 U.S. at 658.

225. SEC v. Cuban, 634 F. Supp. 2d 713, 725 (N.D. Tex. 2009), *vacated*, No. 09-10996, 2010 WL 3633059 (5th Cir. Sept. 21, 2010) (holding that liability "can arise by agreement absent a preexisting fiduciary or fiduciary-like relationship" so long as the agreement imposes a "legal duty to refrain from trading on or otherwise using the information for personal gain"). Unlike the *Cuban* court's rule, the proposed solution does not explicitly extend liability to "fiduciary-like" duties. As explained above, a relationship is only sufficient to serve as the basis of insider trading liability if it includes a duty to refrain from self-dealing, which is the element of the relationship that makes it "fiduciary-like." *See supra* notes 200–01 and accompanying text; *infra* notes 237–39 and accompanying text. Because the fiduciary duty and agreement elements of the proposed solution already encompass duties to refrain from self-dealing both imposed by law and

trading liability because it (1) restricts Rule 10b-5 to its statutory bounds, (2) minimizes the federalization of state law, (3) avoids the adoption of a parity-of-information rule while furthering the goals of the Exchange Act, and (4) allows for the free flow of beneficial information.

First, such a rule limits insider trading liability to the statutory bounds of § 10(b) as required by *Santa Fe*—unlike Rule 10b5-2(b)(1)—because it restricts liability to those who have engaged in deceptive conduct.[226] The Supreme Court clearly established in *Chiarella* and reaffirmed in *Dirks* that one bound by a fiduciary relationship engages in fraud actionable under Rule 10b-5 if he trades on that information for his own benefit.[227] Similarly, a trader who agrees to refrain from self-dealing in nonpublic information but then trades on the information also engages in deceptive conduct as required by § 10(b). As the *Cuban* court noted, a breach of a duty which arose by agreement can be seen as "conferring a stronger footing for imposing liability for deceptive conduct" because the agreement expressly restricted the use of the information for personal gain, whereas a fiduciary duty alone merely creates the duty to refrain by "operation of law due to his relationship with the information source."[228] Because breaching either a fiduciary or an accepted duty to refrain from self-dealing in nonpublic information is deceptive, basing liability on such duties would anchor the prohibition against insider trading to its statutory roots.

Second, restricting liability to those with fiduciary relationships or duties to refrain from benefitting from the information also satisfies *Santa Fe*'s second limitation prohibiting the federalization of common law misconduct in the securities markets.[229] While it may seem that a solution permitting one to accept a duty by agreement would go against *Santa Fe* by allowing the securities laws to delve into the realm of state contract law, a closer examination of the insider trading doctrine reveals that *Santa Fe*'s second limitation on Rule 10b-5 is flexible in regard to insider trading. While the Court in *Santa Fe* held that Rule 10b-5 failed to reach claims in which

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voluntarily agreed upon, additionally extending liability to "fiduciary-like" relationships is unnecessary and redundant.

226. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473 (1977).

227. *See* Dirks v. SEC, 463 U.S. 646, 654 (1983) (noting a duty to disclose arises from the existence of a fiduciary relationship); Chiarella v. United States, 445 U.S. 222, 228 (1980) ("[T]he duty to disclose arises when one party has information 'that the other party is entitled to know because of a fiduciary [relationship] . . . .' ") (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)).

228. *Cuban*, 634 F. Supp. 2d at 725.

229. *Santa Fe*, 430 U.S. at 473–74, 478.

"shareholders were treated unfairly by a fiduciary,"[230] the very essence of claims in classical insider trading cases is that the shareholder is treated unfairly by a fiduciary.[231] Therefore, although the Court in *Santa Fe* attempted to avoid federalizing the portion of state corporate law that deals with securities transactions,[232] this is precisely what the insider trading prohibition does.[233] Because fiduciary relationships themselves are generally defined and regulated by state law, the most extreme application of *Santa Fe* would leave *all* insider trading to state law, rather than federal law.

Additionally, if the courts strictly adhered to *Santa Fe*'s warning against the creation of a federal fiduciary standard, the duty element of the insider trading doctrine would vary from state to state, depending on the fiduciary principles of each jurisdiction. This would be especially problematic in many states where insider trading in fact does not breach the directors' or officers' fiduciary duties.[234] Because it would be absurd to permit insider trading to be legal in these states while it is illegal in others, the securities laws must federalize and rely on *some* common law relationships to determine liability. This view is supported by three Supreme Court decisions in the 1980s in which the Court seemingly viewed the common law as the foundation for Rule 10b-5 liability, along with a decision from 2005 in which the Court again looked to the common law to establish the requirements for private Rule 10b-5 cases.[235] Although the Court has warned against the acceptance of state law misconduct as the basis of federal liability under the securities laws,[236] the message the Court has sent regarding the extent that common law may be used is mixed, at best.

Despite the fact that the Supreme Court precedent is not fully consistent as to the degree to which state common law causes of action may be relied upon in creating insider trading liability, given the

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230. *Id.* at 477.

231. Bainbridge, *supra* note 43, at 1613.

232. *Santa Fe*, 430 U.S. at 479.

233. Bainbridge, *supra* note 43, at 1613.

234. BAINBRIDGE, *supra* note 46, at 59–60.

235. *See* Nagy, *supra* note 84, at 1374–75 (citing Dura Pharms., Inc. v. Broudo, 544 U.S. 336 (2005); Basic Inc. v. Levinson, 485 U.S. 224, 244 n.22 (1988); Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 310 (1985); and Herman & MacLean v. Huddleston, 459 U.S. 375, 389 (1983) as instances in which the Supreme Court has looked to the common law as the foundation for Rule 10b-5 liability).

236. *See, e.g.*, Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 162 (2008) ("Section 10(b) does not incorporate common-law fraud into federal law."); Marine Bank v. Weaver, 455 U.S. 551, 556 (1982) ("Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud."); *Santa Fe*, 430 U.S. at 479–80 (noting that federal fiduciary standards should not be supplied by judicial extension of § 10(b) and Rule 10b-5).

ruling in *Santa Fe*, the Court's adoption of the common law should at least be minimized. Adopting the proposed rule would leave the amount of federalized common law essentially unchanged because the emphasis of the insider trading doctrine is already on prohibiting self-dealing in nonpublic information by those with a duty to refrain from doing so. The principal aspect of fiduciary relationships that courts have focused on in establishing liability is the fiduciary's duty to refrain from self-dealing.[237] Indeed, a central reason the Supreme Court originally adopted the duty requirement in *Chiarella* was to ensure that those "who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information."[238] The Court again heavily relied on the fiduciary's duty to abstain from self-dealing in *Dirks* by establishing that the test for tipper-tippee insider trading liability is "whether the insider personally will benefit, directly or indirectly, from his disclosure."[239] Because the doctrine already prohibits trading on nonpublic information in violation of a duty to abstain from self-dealing, this duty has already been federalized by the Court. Extending insider trading liability to agreements forbidding the use of the information for personal gain would therefore not federalize common law beyond what is already within the federal realm. Thus the proposed solution satisfies the requirement of *Santa Fe* that the securities laws should attempt to avoid federalizing state common law.

Third, a rule extending liability only to those with a duty to refrain from self-dealing avoids the adoption of a rigid parity-of-information rule while continuing to further the goals of the Exchange Act. The Supreme Court in *Dirks* recognized the importance of avoiding a parity-of-information rule by noting that allowing securities analysts to obtain and utilize material, nonpublic information is "necessary to the preservation of a healthy market."[240] Allowing investors to "ferret out and analyze information" and then use this information enhances market efficiency, aids in the accurate

237. *See* Dirks v. SEC, 463 U.S. 646, 659 (1983) ("[I]nsiders [are] forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage . . . ."); Chiarella v. United States, 445 U.S. 222, 228–29 (1980) (noting that because corporate insiders obtain the confidential information from their position, they have a duty to disclose it before trading to avoid taking unfair advantage of the stockholders); *see also* Bainbridge, *supra* note 19, at 1203 (arguing the fiduciary duty relevant to insider trading liability is the duty to refrain from self-dealing).

238. *Chiarella*, 445 U.S. at 230.

239. *Dirks*, 463 U.S. at 662.

240. *Id.* at 658.

pricing of securities, and ensures honest securities markets.[241] By only restricting the use of nonpublic information when it is in the hands of those who have a duty to not personally gain from the information, this solution encourages investors to search for such information without placing a moratorium on its use. At the same time, the proposed solution satisfies the Exchange Act's goals of promoting honesty and investor confidence in the securities markets because all those who are under any type of duty to not personally benefit from nonpublic information will be excluded from trading.[242] In this way, the proposed rule adequately balances the goals of promoting investor confidence and creating honest securities markets without restricting the use of all nonpublic information in securities transactions.

Finally, this solution also allows for beneficial and necessary information to be shared by corporate officials without the concern that it will be used for the personal gain of another. There are often times when disclosure of inside information to a party who has no fiduciary or similar obligation to the corporation or its shareholders is either necessary or economically beneficial, and in such circumstances, disclosure of the nonpublic information should be encouraged.[243] However, corporate officials must also be allowed to restrict the use of this information to ensure that it is not used to the detriment of shareholders. Allowing corporations to share information and limit the use of that information by an agreement to abstain from personally benefitting from its use promotes market fairness while still allowing the confidential information to be disclosed. The SEC would likely accept such a rule because it would permit information to be shared as needed, yet continue to allow for prosecution of those who fraudulently self-deal in the information. Indeed, permitting duties to refrain from self-dealing to arise through agreement is likely what the SEC was attempting to establish by enacting Rule 10b5-2(b)(1) in the first place, as it was meant to "reflect[] the common-sense notion . . . [that the required duty] can be created by an agreement between two

241. *Id.* (quoting *In re* Raymond L. Dirks, Exchange Act Release No. 17,480, 21 SEC Docket 1401, 1981 WL 36329, at *6 (Jan. 22, 1981)).

242. *See* United States v. O'Hagan, 521 U.S. 642, 658 (1997) (stating the purpose of the Exchange Act).

243. *E.g.*, *Chiarella*, 445 U.S. at 224 (disclosure to printer necessary so that the announcements of corporate takeover bids could be made); SEC v. Cuban, 634 F. Supp. 2d 713, 717 (N.D. Tex. 2009), *vacated*, No. 09-10996, 2010 WL 3633059 (5th Cir. Sept. 21, 2010) (disclosure of nonpublic information regarding a PIPE offering to a wealthy investor to enlist his participation and raise capital); *see also* Beeson, *supra* note 50, at 1113 (noting an over-inclusive duty to disclose would deter the free flow of information beneficial to the market).

parties."[244] Additionally, the proposed solution would likely be accepted by the Supreme Court. In *Dirks*, the Court found that confidential information could, and in some cases should, be shared, and that liability would not arise unless the "insider personally will benefit, directly or indirectly, from his disclosure."[245]

Because a rule limiting insider trading liability to fiduciaries and those who by agreement accept a duty to abstain from self-dealing satisfies all the criteria of a workable rule, the proposed solution should be adopted to fill the void created by abandoning Rule 10b5-2(b)(1).

B. Liability Should Not be Limited to Those with Fiduciary Duties

While some contend that liability should be limited to relationships bearing the "hallmark characteristics" of traditional fiduciary relationships,[246] which would mean that an agreement to refrain from self-dealing is insufficient to create liability, such a view is inconsistent with the purpose of the Exchange Act and the development of the insider trading doctrine. The Exchange Act was enacted to ensure the honesty of the securities markets and to promote investor confidence.[247] To do so, § 10(b) prohibits deceptive and manipulative practices to eliminate fraud from the sale or purchase of securities. Limiting liability to those who have fiduciary duties ignores the reality that certain situations—such as in the merger context—may require one party to give confidential information to another. If liability were limited to those with fiduciary duties, then those who are given information for valid business purposes after agreeing to refrain from self-dealing in the information would be able to use the information in the securities markets without federal liability. While there would still be liability under state law for breach of contract, such laws would vary from state to state. Such

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244. Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,603 (Dec. 28, 1999) (to be codified at 17 C.F.R. pts. 230, 240, 243, & 249).

245. *Dirks*, 463 U.S. at 662.

246. *See, e.g.*, United States v. Chestman, 947 F.2d 551, 569 (2d Cir. 1991) (holding discretionary authority and dependency "represent the measure of the paradigmatic fiduciary relationship" and a duty is only sufficient to establish liability if it shares these qualities); United States v. Kim, 184 F. Supp. 2d 1006, 1011, 1015 (N.D. Cal. 2002) (holding that "an express agreement can provide the basis for misappropriation liability only if the express agreement sets forth a relationship with the hallmarks of a fiduciary relationship," such as superiority, dominance, or control); Tyler J. Bexley, Note, *Reining in Maverick Traders: Rule 10b5-2 and Confidentiality Agreements*, 88 TEX. L. REV. 195, 213–14 (2009) (arguing the SEC should be required to prove the classic elements of a fiduciary duty before insider trading liability arises).

247. *O'Hagan*, 521 U.S. at 658.

variation would fail to engender confidence in the market, contrary to what the laws intended, and would discourage parties from making necessary disclosures. Even worse, what would happen to investors such as bondholders, to whom directors and officers owe no fiduciary duties?[248] Under a rule limiting liability to fiduciary relationships, insiders could trade on confidential information in debt securities and completely escape liability! This would obviously be an unreasonable direction for the law to take after abandoning Rule 10b5-2(b)(1).

Additionally, such an argument ignores the development of the insider trading doctrine. While the Supreme Court has always required a party to have a duty to refrain from self-dealing in the confidential information in order to be liable for insider trading, the Court has shown that it is willing to stretch that requirement as needed to promote honest securities markets.[249] In *Dirks*, the Court was willing to extend liability to tippees even though they owe no duties to shareholders.[250] The Court held that a tippee could assume a duty to refrain from self-dealing if the tipper breached a duty in disclosing the information to the tippee.[251] In essence, both the tipper's duty and breach of that duty transfer to the tippee, and this fictional fiduciary relationship is enough to establish liability.[252] The Court's readiness to expand liability to tippees in *Dirks* simply because "[t]he need for a ban on some tippee trading [was] clear"[253] was again evidenced in *O'Hagan*'s acceptance of the misappropriation theory.[254] Allowing a breached duty owed to the source of the information to create insider trading liability—even though the source suffers little or no harm from the breach—further establishes that the Court is willing to stretch the duty requirement if doing so would lead to a desirable policy outcome.[255]

Because *Dirks* and *O'Hagan* both reveal the elasticity of the duty element of insider trading in light of valid policy concerns, limiting the requirement to fiduciary relationships alone would be unduly restrictive. The best solution is to only extend liability to those

248. BAINBRIDGE, *supra* note 46, at 59; *see also* Faith Stevelman, *Globalization and Corporate Social Responsibility: Challenges for the Academy, Future Lawyers, and Corporate Law*, 53 N.Y.L. SCH. L. REV. 817, 840 (2009) (noting directors do not owe fiduciary duties to bondholders as they are expected to protect themselves through the indenture contract).

249. *See supra* notes 107–11 and accompanying text.

250. *Dirks*, 463 U.S. at 660.

251. *Id.*

252. *See* Nagy, *supra* note 84, at 1338 (explaining that this fiduciary fiction was essential to the Supreme Court's decision in *Dirks*).

253. *Dirks*, 463 U.S. at 659.

254. Nagy, *supra* note 84, at 1339.

255. *Id.* at 1339–40.

with fiduciary duties or other obligations to abstain from personally benefitting from the nonpublic information. This approach acknowledges the Court's pliability in regard to the duty requirement while restricting liability to obligations to refrain from self-dealing as the Court has previously done. By adopting such a rule, the efficient disclosure and protection of confidential information the SEC sought to secure by enacting Rule 10b5-2(b)(1) will be achieved without expanding the doctrine beyond its statutory roots.

V. CONCLUSION

While Congress has delegated a great deal of authority to the SEC, such power is not without its limits. One such limit is the Commission's ability to hold liable those who trade on nonpublic information that they only have a duty to keep in confidence. Because such an action is neither deceptive nor fraudulent, holding such a trader liable for the action would exceed the SEC's statutory authority bestowed by § 10(b). Therefore, by enacting Rule 10b5-2(b)(1), which attempts to predicate liability on confidentiality agreements alone, the Commission has gone beyond its delegated authority, and the Rule must be held invalid. However, revoking the Rule would create a void that could possibly deter the disclosure of confidential information when disclosure would be both efficient and beneficial to the market. To fill this void, a rule resting liability only upon fiduciary duties and agreements to refrain from personally benefitting from the use of confidential information should be adopted. This rule best satisfies the purpose of the Exchange Act while remaining within its scope, thereby preventing the Rule 10b-5 "judicial oak" from becoming more expansive than it already is.

Ryan M. Davis[*]

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