 Printed in U.S.A.
Northwestern University Law Review Vol. 106, No. 4

Notes and Comments

A HEART AS FAR FROM FRAUD AS HEAVEN FROM EARTH: *SEC V. CUBAN* AND FIDUCIARY DUTIES UNDER RULE 10B5-2

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ABSTRACT—In 2008, the SEC indicted Dallas Mavericks owner and media mogul Mark Cuban for insider trading based exclusively on information obtained while under an oral confidentiality agreement. The government argued that this agreement was sufficient to establish the necessary duty required under the misappropriation theory based on SEC Rule 10b5-2(b)(1) passed in 2000. This Note argues that a confidentiality agreement is insufficient for establishing the requisite fiduciary or fiduciary-like relationship under the misappropriation theory. Further, this Note argues that the SEC's attempt to circumvent the requirement for a fiduciary or fiduciary-like relationship by promulgating Rule 10b5-2(b)(1) overreaches the power given to the SEC under the Securities Exchange Act.

AUTHOR—J.D., 2012, Northwestern University School of Law. I am very grateful to Professor Alan Horwich for his support and guidance on this project. I would like to thank the whole Editorial Board of the *Northwestern University Law Review*, especially Emily Epstein, Jason Cairns, Peter Siegal, Philip Wiese, Sarah Newman, and Elizabeth Uzelac, for their helpful guidance and careful editing. Finally, I cannot thank my family enough for their endless love and support.

INTRODUCTION

Controversy follows Mark Cuban, the 171st richest person in America,[1] through many of his endeavors. Since his $280 million purchase of the 2011 NBA Champion Dallas Mavericks in 2000,[2] Cuban has been one of the most divisive figures in the NBA.[3] Over the course of his time as owner, Cuban has amassed well over one million dollars in fines for his brash behavior.[4] Cuban's television network, HDNet, has been at the

[1] *See The Forbes 400: The Richest People in America*, FORBES, Oct. 10, 2011, at 210, 236.

[2] Richard Hoffer, *Dallas Maverick*, SPORTS ILLUSTRATED, Nov. 6, 2000, at 80, 82.

[3] *See generally* Michael Lee, *The NBA's True Maverick: Swaggering Billionaire Is Having a Ball*, WASH. POST, June 8, 2006, at E1 (outlining some of Cuban's more memorable moments as a controversial figure in the sport, including his comment that "he wouldn't hire Ed Rush, then the league's director of officials, 'to manage at a Dairy Queen'"—a comment that cost him $500,000 in fines).

[4] *See Mark Cuban NBA Fines: 2000–2006*, http://www.shmula.com/blog/timelines/cuban-fines/cuban-fines.htm (last visited Aug. 26, 2012) (providing a timeline of the fines Cuban received, amounting to $1.46 million, during Cuban's first six years in the league). In 2009, Cuban was highly

forefront of contentious programming, most recently for teaming up with Joe Francis's *Girls Gone Wild* for a risqué reality television show.[5] Cuban drew criticism from the political arena as a producer of the movie *Redacted*,[6] drawing a scathing letter from Congressman Duncan Hunter, Chairman of the House Armed Services Committee, who called the film's portrayal of American troops shameful.[7] Cuban is no stranger to the courtroom, bringing high-profile lawsuits against Zuffa LLC in 2008[8] and the United Football League in 2011,[9] and finding himself as a defendant against Ross Perot Jr. in a suit alleging that the Mavericks were being mismanaged by Cuban and his team.[10]

And in 2008, Cuban had a run-in with the Securities and Exchange Commission (SEC), which claimed that he had committed insider trading in violation of § 10(b) of the Securities Exchange Act[11] (the Exchange Act) and SEC Rule 10b-5[12] in 2004, when he sold his 6.3% stake in the Internet search engine company Mamma.com.[13] The SEC based its claim on Cuban's decision to trade shares after having made an oral agreement with the company's CEO to maintain confidentiality regarding an upcoming securities issuance.[14] While Cuban's choice to agree to confidentiality and

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criticized for stating, "I'm not so against steroids . . . if it's administered under the proper supervision." Kevin Gorman, *Cuban: 'I'm Not So Against Steroids*,*'* PITTSBURGH TRIB.-REV., Oct. 21, 2009, at C12.

5 *See* Leslie Snyder, *Mark Cuban and 'Girls Gone Wild,'* DALLASNEWS.COM (May 6, 2010, 10:29 AM), http://tvblog.dallasnews.com/archives/2010/05/mark-cuban-and-girls-gone-wild.html. For an overview of the programming provided by HDNet, see HDNET, http://www.hd.net (last visited May 7, 2012) (including shows such as *Drinking Made Easy* and *Bikini Barbershop: Jersey*).

6 *See* REDACTED, http://www.redactedmovie.com (last visited Jan. 22, 2011) (listing Mark Cuban as an executive producer of the film).

7 Sara A. Carter, *War Film's Portrayal of Soldiers Draws Fire from GOP Lawmaker*, WASH. TIMES, Nov. 22, 2007, at A3.

8 *See Mark Cuban Sues Zuffa over Couture's Contract*, CAGE TODAY (Feb. 15, 2008), http://www.cagetoday.com/mark-cuban-sues-zuffa-over-coutures-contract.

9 *See* Tom Huddleston Jr., *The Mark Cuban Chronicles: Mavs Owner Sues UFL*, AM LAW DAILY (Jan. 18, 2011, 9:00 PM), http://amlawdaily.typepad.com/amlawdaily/2011/01/cubanufl.html.

10 *See* Brendan Case & Gary Jacobson, *Perot Sues Cuban, Says Mavs Insolvent*, DALL. MORNING NEWS, May 11, 2010, at 1A. In 2011, after the Mavericks won the championship, Cuban's legal team filed a motion for summary judgment showing simply a full-color picture of the Mavericks holding the championship trophy—a motion that one blog called the ultimate "fuck you" brief. Barry Petchesky, *Mark Cuban Files the Ultimate "Fuck You" Legal Brief*, DEADSPIN (June 22, 2011, 12:00 PM), http://deadspin.com/5814461/mark-cuban-files-the-ultimate-fuck-you-legal-brief; World Champion Dallas Mavericks and Radical Mavericks Management's Motion for Summary Judgment, Hillwood Investment Properties III, Ltd. v. Radical Mavericks Management, LLC, No. 10-05639 (Tex. Dist. Ct. Dall. County, June 22, 2011).

11 15 U.S.C. § 78j(b) (2006).

12 17 C.F.R. § 240.10b-5 (2011).

13 SEC v. Cuban, 634 F. Supp. 2d 713, 717 (N.D. Tex. 2009), *vacated*, 620 F.3d 551 (5th Cir. 2010).

14 *See id.* at 718. Liability for insider trading under § 10(b) is grounded exclusively on a confidentiality agreement derived from Rule 10b-5 and further clarified in Rule 10b5-2(b)(1), adopted in 2000 as a response by the SEC to the courts' narrow interpretation of § 10(b) and Rule 10b-5.

to subsequently trade may have been distasteful, this Note argues that his behavior was not actually illegal.

From the original codification of insider trading law in § 10(b) and Rule 10b-5 to the development of the classical theory of insider trading in the early 1980s[15] and the misappropriation theory in the late 1990s,[16] two things have remained constant in analyzing liability. First, under § 10(b), the statute requires a "manipulative or deceptive device" to be used in "connection with the purchase or sale of any security" to give rise to liability.[17] The SEC is limited in its statutory rulemaking authority by the language of the statute itself and therefore cannot create rules for the enforcement of § 10(b) that reach beyond the requirements for either "manipulative or deceptive" behavior.[18] Second, case law regarding both the classical and misappropriation theories of insider trading mandates that, in the case of deception or manipulation caused by lack of appropriate disclosure in the context of a duty to disclose or abstain from trading, a fiduciary or fiduciary-like relationship gives rise to such a duty.[19]

Because the SEC has focused increasingly on insider trading,[20] clarifying when such a duty to disclose or abstain exists has become an increasingly important issue for investor certainty.[21] Three basic questions arise out of *SEC v. Cuban*: (1) Is existing case law sufficient to find that a confidentiality agreement on its own is enough to establish the requisite

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[15] *See* Chiarella v. United States, 445 U.S. 222, 230 (1980).

[16] *See, e.g.*, United States v. O'Hagan, 521 U.S. 642, 650 (1997) (establishing the misappropriation theory as a basis for § 10(b) liability).

[17] 15 U.S.C. § 78j(b) (2006).

[18] *See* Chevron, U.S.A. Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842–43 (1984). This is an oversimplification of *Chevron* deference analysis, which is given a broader explanation and discussion in the analysis of Rule 10b5-2(b)(1) *infra* Part IV.

[19] *See O'Hagan*, 521 U.S. at 666 (explaining the need for a breach of a recognized fiduciary or fiduciary-like duty to find liability); Dirks v. SEC, 463 U.S. 646, 660 (1983) (explaining that when an individual receives information from a source who he knows is breaching a fiduciary duty, the person then has a similar fiduciary duty); *Chiarella*, 445 U.S. at 228 (requiring a fiduciary or similar relationship of trust or confidence).

[20] *See SEC Insider Trading Cases Hit Record in 2008*, REUTERS (Oct. 22, 2008, 12:58 PM), http://www.reuters.com/article/idUSTRE49L65D20081022.

[21] *See, e.g.*, Susan Pulliam et al., *U.S. in Vast Insider Trading Probe*, WALL ST. J., Nov. 20–21, 2010, at A1 (outlining a massive three-year insider trading investigation by the SEC leading to potential widespread indictments as an example of the SEC's heightened interest in insider trading).

The wide scope of potential targets of insider trading scandals is seen in the indictments in connection with the Galleon Group scandal. Those indicted in the hedge fund insider trading case included the billionaire founder of the fund, a McKinsey & Co. consultant, a treasury manager at Intel Corp., and bankers from Morgan Stanley and Bear Stearns. This group is far from the corporate executive suite that one might picture in a traditional insider trading case. *See* Bob Van Voris et al., *2 More Linked to Galleon Case*, S.F. CHRON., Jan. 22, 2011, at D2; John Helyar, *Galleon Insider-Trading Case Opens Window on Secret Hedge Funds*, BLOOMBERG (Oct. 19, 2009, 12:01 AM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a01GJ_ryEtms (outlining the original charges).

relationship for § 10(b) liability?; (2) If existing case law is not sufficient, was the SEC within its rulemaking authority to enact Rule 10b5-2(b)(1), explicitly making such a relationship adequate for a finding of liability?; and (3) If the SEC acted beyond its authority, should such a relationship, as a policy matter, be sufficient for such a finding of insider trading?

Part I outlines the history of insider trading law, including the sources of the classical and misappropriation theories of insider trading, and describes additional cases that further develop the scope of liability under § 10(b). Part II describes the *Cuban* case. Part III argues that the relationship between Cuban and Mamma.com is insufficient for insider trading liability under existing case law, and Part IV argues that the extension of the scope of insider trading liability to include such a relationship under Rule 10b5-2(b)(1) exceeds the scope of the SEC's lawful rulemaking authority. Finally, Part V discusses the future of insider trading liability based exclusively on confidentiality agreements and why the extension of liability to reach these agreements is undesirable.

I. THE STATUTORY BASIS AND CASE LAW DEFINING THE SCOPE OF INSIDER TRADING

A. The Source of Insider Trading Law

The Exchange Act regulates the secondary or post-distribution trading of securities.[22] As the Supreme Court stated, Congress's fundamental goal in securities regulation "was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry."[23] Under § 10(b) of the Exchange Act and the SEC's implementing Rule 10b-5, fraudulent activities are prohibited in connection with the purchase or sale of any security.[24] The intent of the statute and the Rule is to require the periodic disclosure of inside information for the protection of the investors and to promote fair dealing in the trading of securities.[25]

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[22] Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78nn (2006). For an overview of the Exchange Act and securities regulation generally, see JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 5–9 (6th ed. 2009).

[23] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

[24] 15 U.S.C. § 78j(b) (stating that it is unlawful for individuals "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors"); 17 C.F.R. § 240.10b-5 (2006) (implementing this section of the Exchange Act).

[25] *See* Elizabeth Williams, Annotation, *Recipients of Corporate Information Other than Directors, Officers, Substantial Shareholders, or Associated Professionals as Subject to Liability for Trading on Material, Nonpublic Information, Sometimes Referred to as "Insider Trading," Within § 10(b) of the Securities Exchange Act of 1934 (15 U.S.C.A. § 78j(b))—and SEC Rule 10b-5 Promulgated Thereunder—Making Unlawful Corporate Insider's Nondisclosure or Manipulation of Information to*

Although the statute does not explicitly prohibit the conduct commonly referred to as insider trading, the courts have used § 10(b) of the Exchange Act as the basis for restricting this practice.[26] Section 10(b) of the Exchange Act restricts the use of a "manipulative or deceptive device or contrivance" "in connection with the purchase or sale of any security . . . ."[27] To establish manipulative or deceptive behavior, the statute requires a showing of fraud or deceit.[28] Generally, showing a misrepresentation of a material fact upon which another individual detrimentally relied is necessary to demonstrate fraud.[29] In the case of insider trading, such a misrepresentation can occur either through a direct misrepresentation or by silence in the face of an obligation to speak.[30] Based on the language in § 10(b) and Rule 10b-5, deceptive conduct is required to establish insider trading liability.[31]

In the years since the adoption of Rule 10b-5, courts have developed two dominant insider trading liability theories: the classical theory and the misappropriation theory.[32] The classical theory of insider trading focuses on the traditional idea of a corporate insider, while the misappropriation theory targets the deceptive misappropriation of information based on a fiduciary or fiduciary-like relationship of trust or confidence.[33] The courts developed each of these tests to establish the presence of an affirmative obligation to speak or abstain from trading, which is the foundation for showing a deceptive practice.

Seller or Purchaser of Corporation's Stock, 14 A.L.R. FED. 2d 401, 411–12 (2006). For an overview of the potential detrimental effects of insider trading, see WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING 24–39 (3d ed. 2010) (outlining the potential harms of ensuring an honest securities market to the corporation due to misaligned incentives, to an employer when that employer is not the stock issuer, and to the trading public due to wider bid–ask spreads).

[26] *See* Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1323 (2009); Williams, *supra* note 25, at 413. It is interesting to note that before the Exchange Act, there was no law to suggest that the act of insider trading was a breach of fiduciary duty, but the Senate Hearings regarding the 1934 Act faced the issue in a conclusive manner without significant debate. *See* S. REP. NO. 73-1455, at 281 (1934). The practices were called "vicious" and "unscrupulous" in the Report of the Senate committee while prior to these hearings they had not been so demonized. *Id.*; *see also* 2 THE COLLECTED WORKS OF HENRY G. MANNE: INSIDER TRADING 18–19 (Fred S. McChesney ed., 2009) [hereinafter MANNE].

[27] 15 U.S.C. § 78j(b).

[28] *See* Nagy, *supra* note 26, at 1323.

[29] *See id.*; *see also* RESTATEMENT (SECOND) OF TORTS § 525 (1977) (defining liability for fraud and explaining that the plaintiff must prove that the defendant "fraudulently [misrepresented a] fact, opinion, intention or law for the purpose of inducing [the plaintiff] to act . . . [causing] pecuniary loss . . . by his justifiable reliance upon the misrepresentation").

[30] Nagy, *supra* note 26, at 1323.

[31] *See* 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5 (2011); *see also* Nagy, *supra* note 26, at 1323.

[32] *See* Williams, *supra* note 25, at 417.

[33] *See* Nagy, *supra* note 26, at 1324–36.

B. The Classical Theory of Insider Trading

In 1980, the Supreme Court defined the "classical theory" of insider trading in *Chiarella v. United States*.[34] The Court reaffirmed this theory three years later in *Dirks v. SEC*.[35] Under the classical theory, a 10b-5 violation occurs when a corporate insider trades in the securities of a corporation of which he is a director or employee (including an officer) when in possession of material nonpublic information.[36] However, liability arises in violation of § 10(b) under the classical theory only if the trader: (1) owes a fiduciary duty[37] to the other party in the transaction, (2) is an insider with a fiduciary duty to the corporation whose shares he is trading, or (3) is a tippee[38] who knew or should have known that the insider who gave him information had breached a fiduciary duty in doing so.[39] Importantly, this means that the classical theory does not extend to individuals who are not insiders of the corporation and who did not receive the information from an insider.[40]

In *Chiarella*, the Supreme Court considered the actions of a financial printer who was responsible for printing several corporate takeover bids.[41] Vincent Chiarella used the documents to deduce the names of the target corporations, which were otherwise concealed, and he subsequently used this information to trade in the stocks of the targets, realizing considerable profits.[42] The Second Circuit upheld the district court's conviction of Chiarella for violations of § 10(b) and Rule 10b-5.[43] On appeal, the Supreme Court reversed the conviction, stating "that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information."[44] Rather, the Court held that an individual must have a duty to

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[34] 445 U.S. 222 (1980). Before *Chiarella*, courts took an equal-access-to-information approach to insider trading. *See, e.g.*, SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc) (establishing a policy that required anyone who possessed material, nonpublic information to disclose it or abstain from trading on that information).

[35] 463 U.S. 646 (1983).

[36] *See* Williams, *supra* note 25, at 412.

[37] A fiduciary is defined as "[a]n individual in whom another has placed the utmost trust and confidence to manage and protect property or money. The relationship wherein one person has an obligation to act for another's benefit." 4 GALE ENCYCLOPEDIA OF AMERICAN LAW 431 (3d ed. 2011). In the context of a corporate insider, this refers to the relationship that the corporate officers and employees have with the business's owners or shareholders.

[38] A tippee is an individual receiving information from an individual with a fiduciary duty, even if the tippee himself may not have a fiduciary duty.

[39] *See* Nagy, *supra* note 26, at 1324–30.

[40] *Id.* at 1330.

[41] Chiarella v. United States, 445 U.S. 222, 224 (1980).

[42] *Id.*

[43] *See* United States v. Chiarella, 588 F.2d 1358, 1362 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).

[44] *Chiarella*, 445 U.S. at 235.

speak when an allegation of fraud is based on nondisclosure.[45] This duty to disclose when an individual has information exists when "the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."[46]

Although there are five independent exceptions to the general common law rule that only statements are actionable as fraud,[47] the *Chiarella* Court focused exclusively on the first exception: disclosure requirements based on the existence of a fiduciary or other relationship of trust and confidence.[48] The Court could have easily invoked some of the other exceptions, which do not require a fiduciary relationship, but the majority's focus was exclusively on this fiduciary-based duty.[49] This spotlight on the fiduciary requirement considerably narrowed the scope of potential insiders covered by Rule 10b-5 by narrowly looking at the traditional corporate insider, without providing room for broader liability that was available pre-*Chiarella*.[50] Although the Court did not explain its choice to focus only on this exception, it is suggestive of a narrower conception of who might be a potential insider.

Three years after the *Chiarella* decision, the Supreme Court supported expanding the scope of individuals who could potentially be liable for insider trading.[51] In *Dirks*, the Court explained that a tippee without a fiduciary duty to the shareholders could be liable if he knew or should have known that the source of information—the tipper—breached a fiduciary duty to the shareholders by disclosing the information.[52] The Court, in characterizing the SEC's argument, explained that any individual who "knowingly receives nonpublic material information from an insider has a fiduciary duty to disclose before trading."[53] *Dirks* focused on the tipper's fiduciary duty, even though that duty was once removed from the tippee

[45] *See id.*

[46] *Id.* at 228 (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1977)).

[47] The five independent exceptions offered in the *Restatement* are:

> (a) matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them; and (b) matters known to him that he knows to be necessary to prevent his partial or ambiguous statement of the facts from being misleading; and (c) subsequently acquired information that he knows will make untrue or misleading a previous representation that when made was true or believed to be so; and (d) the falsity of a representation not made with the expectation that it would be acted upon, if he subsequently learns that the other is about to act in reliance upon it in a transaction with him; and (e) facts basic to the transaction, if he knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts.

RESTATEMENT (SECOND) OF TORTS § 551(2)(a)–(e) (1977).

[48] *See Chiarella*, 445 U.S. at 227.

[49] Nagy, *supra* note 26, at 1325–26.

[50] *Id.* at 1326.

[51] *See* Dirks v. SEC, 463 U.S. 646 (1983).

[52] *Id.* at 660.

[53] *Id.* at 656.

himself. In other words, the tippee's choice to trade when he knew or should have known that the tipper was breaching a fiduciary duty created a derivative duty of disclosure for the tippee.[54] Together, *Chiarella* and *Dirks* define the traditional scope of individuals facing potential insider trading liability under § 10(b) and Rule 10b-5.

Not all trades by a corporate insider who owes a fiduciary duty to shareholders are considered insider trading under the classical theory. Corporate insiders trade a significant amount of their own company's stock well within the rules set forth in the statutes.[55] However, when a corporate insider has material nonpublic information, the insider has a duty either to abstain from trading or disclose the information before trading.[56] Therefore, under the classical theory, it is not sufficient to show that the trader simply was an insider in the corporation with a fiduciary duty to disclose or abstain. Instead, insider trading liability is predicated on a showing that the individual possessed material nonpublic information and traded securities without disclosing the undisclosed information to the public. In doing so, the insider has then breached his fiduciary duty.[57] The classical theory remained the only insider trading theory endorsed by the Supreme Court until 1997, when the Court legitimized the misappropriation theory, allowing, among other things, insider trading liability for "outsiders" of corporations.[58]

C. The Misappropriation Theory of Insider Trading

Language in the *Chiarella* dissent and concurrence suggested that there was potential for a second theory of insider trading liability.[59] In his dissent, Chief Justice Burger argued that the misappropriation of information obtained through fraud on the source of the information could be the basis

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[54] *Id.* at 659.

[55] *See* 15 U.S.C. § 78(j) (2006); Josef Lakonishok & Inmoo Lee, *Are Insider Trades Informative?*, 14 REV. FIN. STUD. 79, 85 (2001) (finding that, in a typical year, insider trading accounts for 2% of small stocks and about 0.5% of large stocks). In fact, since trading by corporate insiders must be reported to the SEC, many traders in the general public use the information on these trades to guide personal trading strategy. *See How to Legally Profit from Insider Trading!*, INSIDERBUYINGEXPERTS, http://www.insiderbuyingexperts.com (last visited Apr. 8, 2012) (providing a strategy to do trading based on insider trading of corporate officers).

[56] *See* Chiarella v. United States, 445 U.S. 222, 230 (1980); COX ET AL., *supra* note 22, at 884.

[57] *See* Nagy, *supra* note 26, at 1325.

[58] *See id.* at 1325–30; *see also* United States v. O'Hagan, 521 U.S. 642, 650 (1997) (finding liability based on misappropriation for the first time).

[59] *See Chiarella*, 445 U.S. at 238 (Stevens, J., concurring); *id.* at 240 (Burger, C.J., dissenting). Although the dissent by Chief Justice Burger and the concurring opinion by Justice Stevens both point in this direction, the majority opinion "repeatedly emphasized that the SEC should obtain statutory authority from Congress before proceeding to implement its expansive theories about the sorts of corporate acts that constitute securities fraud." JONATHAN R. MACEY, INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY 60 (1991).

for § 10(b) liability.[60] Justice Stevens, in his concurrence, agreed that although it was not properly pleaded in *Chiarella*, fraud on the source of the information could be a viable basis for insider trading liability.[61] Soon the SEC, supported by some courts of appeals, began using this theory of fraud on the source of information by a corporate outsider in subsequent insider trading cases.[62]

In 1997, the Supreme Court embraced the misappropriation theory of insider trading in *United States v. O'Hagan*.[63] Under the version of the misappropriation theory embraced by the Supreme Court, a corporate outsider can be found liable under § 10(b) and Rule 10b-5 when a fiduciary profits from a securities transaction based on the undisclosed use of material nonpublic information obtained from a principal.[64] The *O'Hagan* Court explained that the misappropriation theory of liability is premised "on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."[65] In finding liability under these circumstances, the Supreme Court endorsed, for the first time, the idea that liability under § 10(b) and Rule 10b-5 is not limited to traditional corporate insiders. Rather, liability can also reach an individual who has access to confidential information through a fiduciary or fiduciary-like duty and breaches that duty by misappropriating that information to trade securities for a profit.[66] Under this theory, the deception is not on the other party in the securities transaction; it is on the source of the information.

In *O'Hagan*, the respondent was a partner at Dorsey & Whitney, a law firm hired to represent Grand Metropolitan PLC in a potential tender offer for Pillsbury Company's common stock.[67] James O'Hagan was not working on the deal.[68] However, using the nonpublic knowledge of the potential tender offer that he had gained through his position at the firm, O'Hagan purchased 2500 call options for Pillsbury stock, more than any other

[60] *See Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting) (reasoning that the "broad language [of § 10(b) and Rule 10b-5] negates the suggestion that congressional concern was limited to trading by 'corporate insiders' or to deceptive practices related to 'corporate information'").

[61] *See id.* at 238 (Stevens, J., concurring) (explaining that "[r]espectable arguments could be made" to support a liability theory based on fraudulent activity toward the source of the information).

[62] *See* COX ET AL., *supra* note 22, at 888; *see, e.g.*, United States v. Newman, 664 F.2d 12, 17 (2d Cir. 1981) (applying the misappropriation theory from Burger's dissent in *Chiarella*).

[63] 521 U.S. 642.

[64] *See id.* at 652–53; *see also* Nagy, *supra* note 26, at 1317–18. *O'Hagan* was not the first time the Supreme Court discussed the misappropriation theory after *Chiarella*. In *Carpenter v. United States*, 484 U.S. 19 (1987), the Court upheld a conviction from the Second Circuit premised on the misappropriation theory. But the decision was split evenly on an eight-member Court, so the decision had no precedential effect. *See* WANG & STEINBERG, *supra* note 25, at 416–17.

[65] *O'Hagan*, 521 U.S. at 652.

[66] Nagy, *supra* note 26, at 1317–18.

[67] *O'Hagan*, 521 U.S. at 647.

[68] *Id.*

individual investor, as well as 5000 shares of Pillsbury common stock.[69] Through these transactions and the eventual tender offer, O'Hagan made a profit exceeding $4.3 million.[70] The Department of Justice brought a fifty-seven-count indictment against O'Hagan, alleging that he defrauded his law firm and his client by using inside information to profit through personal trading.[71] In reversing the holding of the Eighth Circuit, the Supreme Court endorsed the misappropriation theory, explaining that the theory fulfills the statutory requirements for "(1) using any deceptive device (2) in connection with the purchase or sale of securities."[72]

First, the Court assessed whether O'Hagan used a deceptive device in the securities transactions. Justice Ginsburg, writing for the Court, explained that although O'Hagan had not directly deceived the other party involved in the options and stock trades, when a fiduciary pretends loyalty to a principal for the purpose of secretly converting the principal's material nonpublic information into personal gain, fraud has occurred on the principal.[73] The deception under the misappropriation theory, according to the Court, was akin to embezzlement—"the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another."[74] By using the confidential information gained through the fiduciary relationship for personal gain without disclosure to the source, the fiduciary deceives the source for § 10(b) purposes.

The Court then addressed the question of whether the deceptive use of the information was in connection with the purchase or sale of a security. In finding a connection between the deceptive device and the trading of securities, the Court explained that the "element is satisfied because the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities."[75] By using a fiduciary relationship to gain material nonpublic information and then, without disclosure, by using that information as the basis for trading securities, the connection was formed between the deceptive device and the trade.[76] Without the trade itself, mere possession of the information would not violate securities law.[77]

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[69] *Id.* at 647–48.

[70] *Id.* at 648.

[71] *Id.*

[72] *Id.* at 651.

[73] *Id.* at 653–54.

[74] *Id.* at 654 (quoting Carpenter v. United States, 484 U.S. 19, 27 (1987)) (internal quotation marks omitted).

[75] *Id.* at 656.

[76] *See id.*

[77] *See id.*

The decision in *O'Hagan* established that outsider liability under § 10(b) and Rule 10b-5 is "limited to those who breached a recognized duty" owed to the source of the material nonpublic information.[78] Referencing the term fiduciary seventeen times,[79] the Court grounded its decision on the fraud committed on the investors who were owed the duty and rejected an approach to liability that was not dependent on a recognized duty.[80] The *O'Hagan* Court explained that a theory that was not grounded in a recognized duty would be overly broad.[81]

Unfortunately, the *O'Hagan* Court did not make any serious attempt to define what actually constitutes the fiduciary or fiduciary-like relationship required for finding liability. The Court in *O'Hagan* began with the assumption that all lawyers are fiduciaries and, as fiduciaries, owe a duty to refrain from using a client's confidential information without disclosure to the client; accordingly, the misappropriation theory applies to all fiduciaries.[82] The ABA Model Rules state: "A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client gives informed consent . . . ."[83] Assuming that this rule states a lawyer's fiduciary responsibility to a client, it is unclear, without further investigation, whether O'Hagan violated this duty because not all trading by an attorney is inherently disadvantageous to a client.[84] Lawyers are not restricted from all trading in clients' securities, but only from that trading which would disadvantage the clients. The Court's approach falls short in providing an adequate definition of fiduciary (or of similar relationships of trust or confidence), and it therefore becomes essential to look beyond *O'Hagan* to identify who is a fiduciary for the purpose of misappropriation theory liability.

D. *Defining Fiduciary Duty in the Context of Insider Trading*

Because *O'Hagan* fails to define a fiduciary or fiduciary-like relationship for § 10(b) and Rule 10b-5 liability, it is necessary to scour other sources for a definition. Before the SEC enacted Rule 10b5-2 (discussed *infra*), the Supreme Court did not provide a clear explanation of

[78] *Id.* at 666.

[79] Nagy, *supra* note 26, at 1332.

[80] *See O'Hagan*, 521 U.S. at 655 n.6. Chief Justice Burger's theory in *Chiarella* proposed that "a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading." *Id.* (quoting Chiarella v. United States, 445 U.S. 222, 240 (1980) (Burger, C.J., dissenting)) (internal quotation marks omitted).

[81] *See id.*

[82] *See* STEPHEN M. BAINBRIDGE, SECURITIES LAW: INSIDER TRADING 123 (2d ed. 2007).

[83] MODEL RULES OF PROF'L CONDUCT R. 1.8(b) (2011).

[84] BAINBRIDGE, *supra* note 82, at 123.

what constituted a fiduciary-like relationship. Therefore, the most useful source of guidance comes from appellate court precedent.[85]

United States v. Chestman is the leading case examining the nature of a fiduciary-like relationship.[86] The defendant, Robert Chestman, was a stockbroker working for Keith Loeb, the husband of one of the members of the Waldbaum family, owners of Waldbaum, Inc.[87] Despite a series of promises of confidentiality among the Waldbaum family, Loeb eventually learned from his wife of a pending sale of the company to the Great Atlantic and Pacific Tea Company (A&P).[88] He discussed this information with his broker, Chestman, revealing that he had knowledge of the impending sale of Waldbaum at a price "substantially higher" than market price.[89] Chestman then used this information to purchase shares for himself, as well as for several clients.[90] Chestman was convicted of ten counts of securities fraud under Rule 10b-5, and his conviction was reversed on appeal.[91] The Second Circuit Court of Appeals, en banc, vacated the panel's decision and reversed the Rule 10b-5 convictions.[92]

To assess liability, the court examined whether Keith Loeb owed a fiduciary duty to his wife, which he then violated by tipping off Chestman and trading Waldbaum stock.[93] Without finding the requisite fiduciary duty there could not have been any way to establish a duty for Chestman to disclose or abstain, resulting in no liability under Rule 10b-5. To determine whether a fiduciary duty existed, the court first noted that "a fiduciary duty cannot be imposed unilaterally by entrusting a person with confidential information," even when the parties are aware of the confidentiality of the

[85] Although the term fiduciary may be defined under state law, state law is not a good source for a definition because inconsistencies between states would create significant problems with uniform enforcement of the federal securities laws. Therefore, *United States v. Chestman* serves as an example of how some appellate courts have interpreted fiduciary-like relationship. 947 F.2d 551 (2d Cir. 1991) (en banc). Although *Chestman* is a Second Circuit opinion, this case is cited by several other circuits (as well as by the Court in *O'Hagan*), suggesting the persuasiveness of the definition articulated by the *Chestman* court.

[86] 947 F.2d 551. *See, e.g.*, Simon DeBartolo Grp., L.P. v. Richard E. Jacobs Grp., Inc., 186 F.3d 157, 169 (2d Cir. 1999) (citing *Chestman* in an insider trading case to outline the definition of fiduciary duty); SEC v. Talbot, 430 F. Supp. 2d 1029, 1046 (C.D. Cal. 2006) (citing *Chestman* to define fiduciary duty); United States v. ReBrook, 837 F. Supp. 162, 167 (S.D. W. Va. 1993), *aff'd in part*, *rev'd in part*, 58 F.3d 961 (4th Cir. 1995) (defining fiduciary); *see also* BAINBRIDGE, *supra* note 82, at 79–85 (using *Chestman* to outline the nontraditional fiduciary relationship).

[87] *See Chestman*, 947 F.2d at 555.

[88] *See id.*

[89] *Id.*

[90] *Id.*

[91] *Id.* at 556. Chestman was also convicted for ten counts of fradulent trading in connection with a tender offer (under Rule 14e-3(a)), ten counts of mail fraud, and one count of perjury. *Id.*

[92] *Id.* at 571. The en banc panel of the Second Circuit also reversed the mail fraud convictions but affirmed the convictions for fraudulent trading. *Id.*

[93] *See id.* at 570–71.

information.[94] The court further explained that "marriage does not, without more, create a fiduciary relationship."[95] Therefore, the exchange of confidential information between a husband and wife, on its own, does not create a fiduciary duty.

The *Chestman* court next assessed whether a "similar relationship of trust and confidence" existed between Loeb and his wife that amounted to the "functional equivalent of a fiduciary relationship."[96] Turning to *Black's Law Dictionary*, the court explained that a fiduciary relationship is defined as one in which "the business which he transacts, or the money or property which he handles, is not his own or for his own benefit, but for the benefit of another person, as to whom he stands in a relation implying and necessitating great confidence and trust on the one part and a high degree of good faith on the other part."[97] The beneficiary of the relationship relies on the fiduciary to act for his benefit by entrusting him with custody over property—here, inside information.[98] The court explained that, by obtaining the property to serve the relationship, the fiduciary "becomes duty-bound not to appropriate the property for his own use."[99]

In the case of Keith Loeb and his wife, the court found that the relationship did not have the necessary qualities of discretionary authority and dependency.[100] The government failed to prove that Keith Loeb received the information because of any type of business relationship. Rather, the information was "gratuitously communicated to him" by his family.[101] The government further failed to show any level of influence or reliance in the relationship between the couple.[102] A fiduciary duty was not created simply by telling a party not to share the information.[103] In *Chestman*, the court made a clear distinction between an individual who

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[94] *Id.* at 567. The court discussed *Walton v. Morgan Stanley & Co.*, 623 F.2d 796 (2d Cir. 1980), where the Second Circuit found that Morgan Stanley was not liable for trading on confidential information regarding a takeover because no preexisting agreement to maintain confidentiality existed. *Chestman*, 947 F.2d at 567. The Court in *Dirks* accepted the reasoning in *Walton*, explaining that *Walton* turned "on the court's determination that the disclosure did not impose any fiduciary duties on the recipient of the inside information." Dirks v. SEC, 463 U.S. 646, 662 n.22 (1983).

[95] *Chestman*, 947 F.2d at 568.

[96] *Id.* (internal quotation marks omitted).

[97] *Id.* at 568–69 (quoting BLACK'S LAW DICTIONARY 564 (5th ed. 1979)).

[98] *See id.*

[99] *Id.* at 569.

[100] *See id.* at 571. The court compared the relationship of Loeb and his wife to the facts of *United States v. Reed*, 601 F. Supp. 685 (S.D.N.Y. 1985), *rev'd*, 773 F.2d 477 (2d Cir. 1985), an earlier case where the court found that a fiduciary-like relationship existed between father and son. *See Chestman*, 947 F.2d at 569. The Court distinguished the two cases because, in *Reed*, the family members repeatedly shared confidential information. *See id.* When family members discuss business affairs frequently, a fiduciary-like relationship may be established. *See id.*

[101] *Chestman*, 947 F.2d at 570.

[102] *Id.*

[103] *See id.* at 570–71.

acquires information and an individual who, through his relationship with the tippee, has a fiduciary duty to disclose or abstain due to the existence of the functional equivalent of a fiduciary relationship.[104] Under the *Chestman* analysis, without an explicit expectation that the tippee will not use the information for his own benefit, a fiduciary-like relationship does not exist.

E. Rule 10b5-2: Defining the Scope of the Misappropriation Theory

The case law developing the misappropriation theory provided a piecemeal analysis of liability under § 10(b) and Rule 10b-5 rather than a systematic approach to analyzing outsider trading liability. *O'Hagan* explained that a fiduciary or fiduciary-like relationship is required for insider trading liability[105] and *Chestman* defined such a fiduciary-like relationship.[106] In 2000, the SEC promulgated Rule 10b5-2, a nonexclusive rule that established the scope of liability under the misappropriation theory by seeking to define a fiduciary or fiduciary-like relationship.[107] Rule 10b5-2 deems a "duty of trust or confidence" to exist in the following situations:

> (1) Whenever a person agrees to maintain information in confidence;
> (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or
> (3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling . . . .[108]

Noticeably lacking in Rule 10b5-2 is a requirement of finding a fiduciary or fiduciary-like relationship for liability. Rather, the language suggests a broader scope under which liability for insider trading could be established. Some commentators have suggested that this becomes particularly apparent by comparing the language of Rule 10b5-2(b)(1) to the language used by the Supreme Court.[109] While Rule 10b5-2(b)(1) references

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[104] *See id.* at 568.

[105] United States v. O'Hagan, 521 U.S. 642, 652 (1997).

[106] *See Chestman*, 947 F.2d at 568–70.

[107] Duties of Trust or Confidence in Misappropriation Insider Trading Cases, 17 C.F.R. § 240.10b5-2 (2011). *See* Selective Disclosure and Insider Trading, Securities Act Release No. 7787, Exchange Act Release No. 42,259, Investment Company Act Release No. 24,209, 71 SEC Docket 732 (proposed Dec. 20, 1999) (proposing release of 10b5-2).

[108] 17 C.F.R. § 240.10b5-2(b).

[109] *See* Amended Brief of Amici Curiae in Support of Defendant's Motion to Dismiss at 2, SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009) (No. 3:08-cv-02050), 2009 WL 1257407. Allen Ferrell, the Greenfield Professor of Securities Law at Harvard Law School, wrote the brief, and Stephen Bainbridge, the William D. Warren Professor of Law at UCLA Law School; M. Todd Henderson, an Assistant Professor of Law at the University of Chicago Law School; Alan R. Bromberg, a University Distinguished Professor of Law at SMU Dedman School of Law; and Jonathan R. Macey, the Sam

a relationship of "trust *or* confidence,"[110] the *Chiarella* and *O'Hagan* courts specifically required a relationship of "trust *and* confidence."[111] Although there is only a subtle distinction in the language, this distinction suggests that Rule 10b5-2(b)(1) is broader than *O'Hagan*'s articulation of the misappropriation theory.[112]

F. Questioning the SEC's Rule 10b5-2

Although several courts[113] have questioned the validity of the SEC's Rule 10b5-2 since it was promulgated, none have actually invalidated it. However, this Note argues that in light of these questions, the validity of Rule 10b5-2 should not be presumed.

In 2003, the Eleventh Circuit Court of Appeals commented, in dicta, on the validity of 10b5-2(b)(3).[114] In *SEC v. Yun*, the court considered Rule 10b5-2(b)(3), which creates a presumed duty to abstain or disclose arising from spousal communication.[115] The *Yun* court noted that "the SEC's new rule goes farther than we do in finding a relationship of trust and confidence."[116] Ultimately, the court found a relationship of trust and confidence based on a history of the husband and wife sharing business information,[117] but articulated the necessity of completing this analysis based on particular facts rather than presuming such a relationship based on the fact of marriage alone.[118] By finding that the prior case law did not provide a basis for a presumption of such a relationship, this ruling suggests that the court believed that Rule 10b5-2 reached beyond the scope of § 10(b).[119]

Harris Professor of Corporate Law, Finance, and Securities Regulation at Yale Law School, all signed the brief. *Id.* at 3.

[110] 17 C.F.R. § 240.10b5-2 (emphasis added).

[111] United States v. O'Hagan, 521 U.S. 642, 652 (1997) (emphasis added); Chiarella v. United States, 445 U.S. 222, 228 (1980) (emphasis added).

[112] Prominent members of the academic community suggested in a brief to the district court in the Cuban case that this was the case. *See* Amended Brief of Amici Curiae, *supra* note 109, at 2.

[113] *See, e.g.*, SEC v. Yun, 327 F.3d 1263 (11th Cir. 2003); United States v. Kim, 184 F. Supp. 2d 1006, 1015 (N.D. Cal. 2002) (stating, in contrast to the language of Rule 10b5-2, 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").

[114] *See Yun*, 327 F.3d at 1273 n.23.

[115] *See id.*

[116] *Id.*

[117] *Id.* at 1273–74. Similar to the father and son in *United States v. Reed*, 601 F. Supp. 685 (S.D.N.Y. 1985), *rev'd*, 773 F.2d 477 (2d Cir. 1985), where family relationships alone were not sufficient to find a fiduciary-like relationship, the business relationship between the family members created such a relationship.

[118] *See Yun*, 327 F.3d at 1272–73.

[119] *See* Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881, 895 n.75 (2010) (coming to the same conclusion

In *United States v. Kim*, a California federal district court examined a relationship where an expectation of confidence was based solely on a history, pattern, and practice of sharing confidential information.[120] In doing so, the court implicitly questioned whether Rule 10b5-2(b)(2) exceeds the SEC's rulemaking power. The trader in *Kim* was a member of the Young Presidents' Organization.[121] The organization's principles stated that the members' forums "operate in an atmosphere of absolute confidentiality."[122] The defendant then traded on information gained while under this expectation of privacy.[123] The *Kim* court found that the mutual expectation of confidentiality was insufficient to establish the relationship of trust and confidence needed for liability under § 10(b).[124] The court stated 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 detailed [in *Chestman*]."[125] Because the court asserted that the dismissal in *Kim* was mandated under § 10(b), the logical end is that Rule 10b5-2 must be considered overbroad, reaching beyond the scope of its statutory source.[126]

Neither *Yun* nor *Kim* go so far as to invalidate any section of 10b5-2. Rather, these cases signify that the validity of Rule 10b5-2 should not be assumed, but rather is an open question for the courts.

II. *SEC v. Cuban* Questions the Validity of Rule 10b5-2(b)(1)

On November 17, 2008, the SEC filed a complaint for insider trading against Mark Cuban after he sold his 6.3% stake in the Internet search company Mamma.com.[127] The complaint alleged that "Cuban violated . . . Section 10(b) of the Securities Act of 1934 . . . and Rule 10b-5 thereunder" by trading securities while employing a deceptive device.[128] The SEC asked the court to: (1) enjoin Cuban from engaging in future violations of these provisions; (2) require Cuban to disgorge the losses that he had avoided; and (3) require Cuban to pay civil penalties under the

regarding the court's language in *Yun* regarding the SEC reaching beyond the scope of § 10(b) with Rule 10b5-2(b)(3)).

120 184 F. Supp. 2d 1006 (N.D. Cal. 2002).

121 *See id.* at 1008.

122 *Id.* (internal quotation marks omitted).

123 *See id.* at 1008–09.

124 *See id.* at 1015.

125 *Id.*

126 *See* Hazen, *supra* note 119, at 896 n.78 (reaching the same conclusion as *Kim*, explaining that the court's decision forces the conclusion that the court believes that "Rule 10b5-2(b)(2) is overbroad since the SEC cannot by rule extend the scope of the statute").

127 Complaint at 1, SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009) (No. 3:08-CV-2050), 2008 WL 4901149.

128 *Id.*

statutory provisions involved.[129] The district court dismissed the case on a Rule 12(b)(6) motion for failure to state a claim upon which relief can be granted.[130] However, the Fifth Circuit Court of Appeals remanded for additional fact-finding on the issue of whether Cuban had actually agreed to nonuse rather than only agreeing to confidentiality.[131] This case signified the first time that a court questioned the SEC's power in promulgating Rule 10b5-2(b)(1).

A. The Facts

In March 2004, Mark Cuban purchased a 6.3% stake, or 600,000 shares, in Mamma.com.[132] Mamma.com was a Canadian company that ran an Internet search engine and was publicly traded on the NASDAQ.[133] Later in 2004, "Mamma.com decided to raise capital through a PIPE offering,"[134] and chose to invite its largest known shareholder, Cuban, to participate in the offering.[135] The CEO began his telephone conversation with Cuban by explaining that he had confidential information to convey, to which Cuban replied that he would keep the information in confidence.[136] The CEO then informed Cuban of the impending offering.[137]

Cuban reacted to the information with concern that the offering would dilute the existing shareholders' (including his own) stake.[138] Cuban ended the call saying, "Well, now I'm screwed. I can't sell."[139] The CEO took this to mean that Cuban would not sell his shares until after the PIPE offering announcement.[140] Over the next few days, Cuban proceeded to sell his entire stake in Mamma.com without informing the company of his intention to sell.[141] Subsequent to Cuban selling his shares, Mamma.com publicly

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[129] *See id.* at 8.

[130] *See* SEC v. Cuban, 634 F. Supp. 2d 713, 731 (N.D. Tex. 2009), *vacated*, 620 F.3d 551 (5th Cir. 2010).

[131] *See Cuban*, 620 F.3d at 558.

[132] *Cuban*, 634 F. Supp. 2d at 717.

[133] *Id.*

[134] *Id.* A private investment in public equity (PIPE) offering is defined as:

> A private investment firm's, mutual fund's or other qualified investors' purchase of stock in a company at a discount to the current market value per share for the purpose of raising capital. There are two main types of PIPEs—traditional and structured. A traditional PIPE is one in which stock, either common or preferred, is issued at a set price to raise capital for the issuer. A structured PIPE, on the other hand, issues convertible debt (common or preferred shares).

Private Investment in Public Equity—PIPE, INVESTOPEDIA, http://www.investopedia.com/terms/p/pipe.asp (last visited Nov. 16, 2010).

[135] *Cuban*, 634 F. Supp. 2d at 717.

[136] *Id.*

[137] *Id.*

[138] *Id.*

[139] *Id.*

[140] *See id.*

[141] *Id.* at 718.

announced the PIPE offering.[142] The company's stock fell 9.3% in the wake of the announcement,[143] and the stock price continued to decline in the following days.[144] In total, Cuban avoided losses in excess of $750,000 by selling his shares before the PIPE offering was publicly announced on June 29, 2004.[145] Following the PIPE offering, Cuban filed required SEC disclosure statements of the sale and publicly stated that he had sold the shares because of the impending PIPE offering.[146]

B. The District Court Ruling

In Cuban's motion to dismiss under Rule 12(b)(6) of the Federal Rules of Civil Procedure, Cuban argued that: (1) the SEC failed to allege that he engaged in insider trading based on its failure to allege that Cuban had the required fiduciary or fiduciary-like relationship and (2) Rule 10b5-2(b)(1) was invalid as applied to create liability in the absence of any fiduciary or fiduciary-like duty.[147] Although the district court held that a relationship that gives rise to insider trading liability under the misappropriation theory need not bear all of the hallmarks of a traditional fiduciary relationship, a mere promise of confidentiality is not sufficient to create the fiduciary-like relationship needed for liability.[148] With regard to the second argument, the court held that applying Rule 10b5-(b)(1) to predicate § 10(b) liability on a mere confidentiality agreement exceeds the SEC's authority under the Exchange Act and therefore cannot be relied on for finding liability.[149]

The district court first examined whether the SEC pled a relationship sufficient for finding § 10(b) liability.[150] Under *Chiarella* and *O'Hagan*, the court recognized that both the classical and the misappropriation theories of

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[142] *Id.*

[143] Jonathan Stempel, *Court Revives Mark Cuban Insider Trading Case*, REUTERS (Sept. 21, 2010, 6:32 PM), http://www.reuters.com/article/2010/09/21/us-sec-cuban-lawsuit-idUSTRE68K33E20100921.

[144] *Cuban*, 634 F. Supp. 2d at 718.

[145] *Id.*

[146] *Id.*

[147] Memorandum of Law of Mark Cuban in Support of Motion to Dismiss at 1–2, SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex 2009) (No. 3:08-CV-2050), 2009 U.S. Dist. Ct. Motions LEXIS 42203. The motion also addressed two questions beyond the scope of this Note. First, Cuban argued that the definition of fiduciary or fiduciary-like relationship is a matter of state law, or, in the alternative, a fiduciary or fiduciary-like relationship was inadequately pled under federal common law. *See id.* Because the court essentially dismissed this issue, it is not discussed in this Note. Cuban also attempted to argue that Rule 10b5-2(b)(1) only applies to family and other personal relationships. *See id.* Since the court jumped directly to arguing that Rule 10b5-2(b)(1) cannot properly rely on a mere confidentiality agreement to establish liability under the misappropriation theory, it did not discuss this argument. *See Cuban*, 634 F. Supp. 2d at 728 n.9. The court did mention that, "[w]ere the court to reach this question, . . . it would . . . reject such a limitation on Rule 10b5-2(b)(1)'s reach." *Id.*

[148] *Cuban*, 634 F. Supp. 2d at 726.

[149] *See id.* at 730–31.

[150] *See id.* at 722–24.

insider trading demand deception for liability.[151] The *Cuban* court explained that "*O'Hagan* teaches that the essence of the misappropriation theory is the trader's undisclosed use of material nonpublic information that is the property of the source, in breach of a duty owed to the source to keep the information confidential and not to use it for personal benefit."[152] The court also noted that *O'Hagan*'s "unmistakabl[e]" focus on the need for deception in the misappropriation theory is further strengthened by *O'Hagan*'s explanation that liability can be foreclosed through the disclosure of the intention to trade.[153] This, according to the court, makes it clear that trading cannot be deceptive under the misappropriation theory without a legal duty to refrain from trading without disclosure.[154]

While Cuban claimed that a fiduciary or fiduciary-like relationship is required under the misappropriation theory, the court found alternative reasons that the relationship required for § 10(b) liability did not exist in this case. The court explained that *O'Hagan*'s view of misappropriation is grounded in the undisclosed breach of a duty not to use someone else's information for personal benefit.[155] This concept provides "no apparent reason why that duty cannot arise by agreement."[156] Therefore, the requisite fiduciary-like relationship may still be found even though the basis for the potential obligation is an agreement. Rather, the court looks more closely at the terms of the agreement to find the lack of a sufficient relationship of trust and confidence. In doing so, the court concluded:

> The agreement, however, must 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. . . . A person who receives material, nonpublic information may in fact preserve the confidentiality of that information while simultaneously using it for his own gain. . . . Absent a duty not to use the information for personal benefit, there is no deception in doing so.[157]

The court further explained that in the context of a nonuse agreement, the trader has created a duty for himself to disclose or abstain, but the source's subjective belief that the recipient is not going to trade in the context of an agreement only not to disclose is insufficient to give rise to a duty.[158] A unilateral understanding by the party providing information that it will not be used for trading does not create a duty with an explicit

[151] *See id.* at 722–23.
[152] *Id.* at 723.
[153] *Id.*
[154] *See id.*
[155] *Id.* at 724.
[156] *Id.*
[157] *Id.* at 725.
[158] *Id.*

agreement to not trade.[159] Additionally, the court explicitly rejected the proposition in *Chestman* and *Kim* that an association requires one party to have superiority or exercise control or dominance to find the requisite fiduciary or fiduciary-like relationship.[160] Therefore, although an agreement may be sufficient to create the duty needed for finding liability under the misappropriation theory, a mere confidentiality agreement, without a provision not to trade, falls short of creating such a duty. For an agreement without a pre-existing fiduciary or fiduciary-like relationship to be sufficient to establish liability, it must create a duty to disclose or abstain, such as in an agreement for nonuse.

The district court also addressed the question of whether Rule 10b5-2(b)(1) is sufficient to establish a duty giving rise to liability under the statute. The court began by asserting that "[t]he SEC's rulemaking authority under § 10(b) is bounded by the statute's proscription of conduct that is manipulative or deceptive."[161] Prior case law establishes that a necessary component of the misappropriation theory is a duty to not trade without disclosing while aware of the confidential information.[162] Therefore, the court explained that it must begin by looking at the plain meaning of § 10(b) and "the language and design of the statute as a whole" to understand whether Rule 10b5-2(b)(1) can appropriately serve as a basis for the misappropriation theory.[163]

The court concluded that Rule 10b5-2(b)(1)'s creation of liability under the misappropriation theory is outside of the scope of the plain language of the statute:

> The agreement specified in the Rule—"to maintain information in confidence"—relates merely to preserving . . . confidentiality . . . . The word "maintain" captures the obligation to keep the information in its existing state, and the modifying phrase "in confidence" indicates that the state to be preserved is its confidentiality. Nothing in Rule 10b5-2(b)(1) requires that the agreement encompass an obligation not to trade . . . .[164]

The court further explained that this reading of Rule 10b5-2(b)(1) is consistent with the language of the remainder of Rule 10b5-2.[165] Each of the other two clauses outlines express or implied undertakings to maintain

[159] *Id. Chestman* is quoted at this point in the decision for the premise that "a fiduciary duty cannot be imposed unilaterally by entrusting a person with confidential information." *Id.* (quoting United States v. Chestman, 947 F.2d 551, 567 (2d. Cir. 1991)).

[160] *See id.* at 726–27.

[161] *Id.* at 728.

[162] *See id.* at 728–29.

[163] *Id.* at 729 (quoting K Mart Corp. v. Cartier, Inc., 486 U.S. 281, 291 (1988)).

[164] *Id.* at 730.

[165] *Id.*

confidentiality without requiring further agreement not to trade on that information.[166]

The court concluded that Rule 10b5-2(b)(1) reaches beyond the bounds of § 10(b) by predicating liability on a mere confidentiality agreement.[167] Such a rule creates insider trading liability when the trader has no duty not to trade.[168] The court explained that "it is the undisclosed use of confidential information for personal benefit, in breach of a duty not to do so, that constitutes the deception."[169] Therefore, the government cannot rely on Rule 10b5-2(b)(1) to impose liability under § 10(b).

C. *The Fifth Circuit Remands*

On September 21, 2010, the Fifth Circuit Court of Appeals filed its opinion regarding the SEC's appeal. The Court of Appeals ultimately did not find it necessary to rule on either of the issues addressed by the lower court. Rather, the court found that "the statement, 'Well, now I'm screwed. I can't sell' [could] plausibly be read to express Cuban's view that learning the confidences . . . forbade his selling his stock before the offering."[170] The court reasoned that this statement, combined with Cuban's subsequent requests for information regarding the PIPE offering, was sufficient to establish a plausible basis for finding that there was not simply a confidentiality agreement between Cuban and the CEO of Mamma.com, but rather there was an implied agreement not to trade.[171] The court suggested that it was at least plausible, for surviving a 12(b)(6) motion to dismiss, that Mamma.com only shared the information based on an agreement, even if only implied, to not use the information for personal benefit.[172] Interestingly, the SEC never made this argument, but rather focused on the confidentiality agreement as the basis for the necessary relationship. One might assume that this suggests that the SEC was attempting to use the Cuban case, one with particularly egregious facts, as a test case for this particular rule.

Rather than ruling on the district court's assessment of whether a relationship of trust or confidence existed or the validity of Rule 10b5-2(b)(1), the court of appeals vacated the judgment and remanded for further proceedings and discovery to assess the possibility that the agreement between Cuban and the CEO went beyond a mere confidentiality agreement.[173] Therefore, the question of liability based on a confidentiality

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[166] *See id.*
[167] *See id.* at 731.
[168] *See id.*
[169] *Id.*
[170] SEC v. Cuban, 620 F.3d 551, 557 (5th Cir. 2010).
[171] *Id.*
[172] *Id.* at 557–58.
[173] *Id.* at 558.

agreement or the SEC's ability to extend the scope of § 10(b) to include this type of situation remains open.[174] The next two Parts of this Note provide an assessment of how courts should address the questions that the Fifth Circuit left open.[175]

III. ABSENT SEC RULE 10B5-2(B)(1), CASE LAW PRECLUDES LIABILITY UNDER A MERE CONFIDENTIALITY AGREEMENT

Section 10(b) of the Exchange Act provides that it is unlawful for a person "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device" in violation of any SEC rule adopted under the section.[176] Rule 10b-5 was promulgated under the statute pursuant to the SEC's rulemaking authority to promulgate "such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[177] Taken together, the statute and the SEC's rule state that an individual cannot manipulate or deceive in connection with securities trading. However, when a deceptive device has been used in trading is not clear. Rather, the definition of deception in this context is murky at best.

Both the classic and misappropriation theories of insider trading are grounded in the existence of a fiduciary or fiduciary-like duty between the source of the information and the trader.[178] After the mandate for a fiduciary or fiduciary-like relationship, the next inevitable question is when a fiduciary-like relationship exists. The widely used analysis from *Chestman* requires that, for a relationship of trust and confidence to be sufficient for liability, it "must be the functional equivalent of a fiduciary relationship."[179] The *Chestman* court focused on the fact that the tipper entrusts the tippee with information for the purpose of serving the ends of the fiduciary relationship.[180] By having this information entrusted to him, the fiduciary

[174] This story has an interesting epilogue. On October 22, 2010, Bloomberg reported that Mark Cuban offered to pay the SEC's lawyers to help speed up the process of reviewing documents for the case to be heard again in the district court. *See* William McQuillen, *Cuban Offers to Hire Lawyers to Review SEC Documents*, BLOOMBERG (Oct. 22, 2010, 12:55 PM), http://webfarm.bloomberg.com/apps/news?pid=conewsstory&tkr=CF1:GR&sid=aigyjdc.H5Fs. The current schedule provided by the SEC has document review running until March 2012, and therefore, Cuban has offered to help hire contract attorneys to push along the process. *See id.* To date, the SEC has rejected the offer, suggesting that if it were to allow Cuban to do so, it would suggest that individuals with deep pockets would be able to push along the legal process where less wealthy individuals could not. *See id.*

[175] This Note does not approach the question that the court of appeals posed in its opinion of whether these questions actually even apply in *Cuban*. Rather, this Note ignores the argument that there may have been an implied nonuse agreement making Rule 10b5-2(b)(1) a moot point.

[176] 15 U.S.C. § 78j(b) (2006).

[177] *Id.*; *see* 17 C.F.R. § 240.10b-5 (2011).

[178] *See supra* Part I.B (explaining the requirement for a fiduciary or fiduciary-like relationship under both theories).

[179] United States v. Chestman, 947 F.2d 551, 568 (2d. Cir. 1991) (en banc); *see supra* Part I.D.

[180] *See Chestman*, 947 F.2d at 568.

then wields a level of influence and control over the tipper because the tipper depends on the tippee to not trade.[181] The opinion states that, simply by providing an individual with material nonpublic information, the requisite duty of trust and confidence is not created.[182] To find a similar relationship of trust and confidence, it is necessary to find the "principal characteristics of a fiduciary relationship—dependency and influence."[183]

Under this definition, a mere confidentiality agreement would be insufficient to create the essential relationship needed to establish § 10(b) liability. Under the *Chestman* analysis, a confidentiality agreement alone could not create a level of authority or dependence on the part of the information source. By agreeing to confidentiality, the potential trader is agreeing to not share that information with others. He is *not* agreeing to use the information solely for the benefit of the source of the information. One could argue that by trading, the tippee is disclosing the information to the public. While this may be true for a very large trade, a smaller trade would likely go unnoticed by the public, especially if the trade is made by an individual who is not required to report his trades as an executive of the company. This is in contrast to a nonuse agreement, where the tippee explicitly agrees to not trade. Although a nonuse agreement does not create a duty to act solely in the interest of the tipper, it does create a direct contractual obligation not to trade. Therefore, the tipper rightfully depends on the tippee to not use the information for trading purposes. Under this analysis, a mere confidentiality agreement, short of a nonuse agreement or some further business relationship providing a level of authority or dependence by the source on the tippee, cannot be the basis for § 10(b) liability.

Some have claimed that the *Chestman* approach to defining a fiduciary-like relationship sets too high a bar.[184] The claim from critics of the *Chestman* approach to fiduciary-like relationships is that the intent of the Exchange Act is to protect investors and assure an honest securities market, and therefore, this definition is too restrictive.[185] This argument lies exclusively in a policy realm. The regulatory scheme could fully protect the integrity of the market and the fairness of the market for individual traders by limiting any trading by all individuals who have material nonpublic

[181] *See id.* at 568–69.

[182] *See id.* at 567.

[183] *Id.* at 569.

[184] *See* SEC v. Yun, 327 F.3d 1263, 1273 n.23 (11th Cir. 2003) (refusing to take what the *Yun* court considered to be an overly narrow approach to defining a fiduciary-like relationship). The SEC called *Chestman*'s parameters too narrow and claimed that they failed to "sufficiently protect investors and the securities markets from the misappropriation and resulting misuse of inside information." Selective Disclosure and Insider Trading, Securities Act Release No. 7787, Exchange Act Release No. 42,259, Investment Company Act Release No. 24,209, 71 SEC Docket 732, 749 (proposed Dec. 20, 1999) (proposing release of Rule 10b5-2).

[185] *See Yun*, 327 F.3d at 1273 n.23.

information. However, this is not the regulatory scheme in the United States.[186] Access to material nonpublic information on its own is inadequate for establishing liability under § 10(b).[187] The statute requires the use of a deceptive or manipulative device before insider trading liability can be established.[188] Therefore, although courts have yet to clearly define the characteristics of a fiduciary-like relationship, the argument against the *Chestman* analysis that it fails to fully protect the general investor is an argument for an overhaul of the regulatory scheme.

Even without relying on the definition of fiduciary-like relationship offered in *Chestman*, a mere confidentiality agreement is not sufficient to establish § 10(b) liability. Even a far broader definition of fiduciary-like relationship could not logically include the type of relationship seen in *Cuban*. The district court in *Cuban* offered an expanded definition of the type of relationship of trust or confidence needed for liability under § 10(b). The court understood *O'Hagan* to mean that a fiduciary or fiduciary-like relationship was sufficient, but not necessary, for establishing § 10(b) liability.[189] The court also acknowledged that nothing in the *O'Hagan* decision would stop a contractual agreement from being sufficient to establish the requisite relationship for liability.[190] However, the court explained further that a mere confidentiality agreement would be insufficient. In order to establish a duty, based on an agreement, to not trade on the information, a nonuse agreement would be necessary. Under the terms of a confidentiality agreement, keeping the information confidential but trading based on that information is not deceptive as required by statute.[191]

The *Cuban* court makes an interesting but exclusively semantic argument. The court explains that "a duty analogous to the fiduciary's duty of 'loyalty and confidentiality' can be created by agreement."[192] Here, the *Cuban* court defines the relationship created by an agreement as conceptually different from (although analogous to) a fiduciary-like relationship. The distinction drawn by the *Cuban* court is unnecessary. An easier conceptual approach is that a contractual nonuse agreement creates a fiduciary-like relationship for the purpose of § 10(b) liability. In order for an agreement to succeed in creating such a relationship, the resulting relationship must contain the elements of a fiduciary-like relationship. A mere confidentiality agreement, unlike a nonuse agreement, does not

186 *See supra* Part I (providing overview of the regulatory scheme).

187 *See Chestman*, 947 F.2d at 567.

188 15 U.S.C. § 78j(b) (2006).

189 SEC v. Cuban, 634 F. Supp. 2d 713, 724 n.5 (N.D. Tex. 2009), *vacated*, 620 F.3d 551 (5th Cir. 2010).

190 *Id.* at 724.

191 *Id.* at 725.

192 *Id.* at 724.

provide the source of deception—a duty not to use for one's personal benefit followed by trading—to establish liability.

While the reasoning here reaches the same broad conclusion as the district court, there is one important difference. While the *Cuban* court suggests a new type of relationship sufficient for § 10(b) liability—one created by an agreement—the analysis in this Note is more consistent with prior case law. Rather than broadening the scope of § 10(b) by adding this type of relationship, this Note suggests that a nonuse agreement has the potential to create the requisite fiduciary-like relationship. In either approach, while a nonuse agreement may be sufficient for establishing liability, a mere confidentiality agreement would never be enough. To create the type of fiduciary or fiduciary-like relationship required under *O'Hagan* to find liability under § 10(b), there must be an actual duty not to trade. A duty to keep the information confidential is insufficient to clear the bar for showing the requisite duty.

IV. SEC RULE 10B5-2(B)(1) IS AN INVALID USE OF THE SEC'S RULEMAKING POWER

This Note has established that, under the current case law interpreting § 10(b), a mere confidentiality agreement is insufficient to establish the duty necessary to meet the deception requirement.[193] Despite these decisions, the SEC promulgated Rule 10b5-2(b)(1), which explicitly states that a confidentiality agreement is sufficient for creating liability under the misappropriation theory.[194] The question then becomes whether it was within the SEC's administrative authority to enact such a rule. In an amicus curiae brief for the court in the *Cuban* case, several scholars asserted that this is beyond the scope of the SEC's power.[195] The next section outlines the test under which the SEC's rulemaking power must be measured and then assesses Rule 10b5-2(b)(1) under this rubric.

A. Defining the SEC's Rulemaking Power

The SEC's power under § 10(b) is not unlimited. Rather, "[t]he rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. . . . [I]t is the power to adopt regulations to carry into effect the will of Congress as expressed by the statute."[196] The validity of an administrative agency's rule is measured under the well-known test developed in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*[197]

[193] *See supra* Part III.
[194] 17 C.F.R. § 240.10b-5(b)(1) (2011).
[195] *See* Amended Brief of Amici Curiae, *supra* note 109, at 2.
[196] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 213–14 (1976) (internal quotation marks omitted).
[197] 467 U.S. 837 (1984).

First, the courts only defer to the regulatory agency's interpretation of a statute if Congress has not made its intent clear in the statutory text.[198] If Congress has not expressed a clear intent, then the court must defer to any reasonable interpretation of the administrative agency, rather than imposing its own construction.[199] To make this threshold determination, the court does not look at the particular provision in isolation, but rather looks at it in the context of the overall statutory scheme.[200] In a case where the statutory language is ambiguous and Congress has left room for an agency to further explain a provision, the court will defer to the administrative agency's interpretation as long as the interpretation is not "arbitrary, capricious, or manifestly contrary to the statute."[201]

Beyond the *Chevron* test, in cases where the court has already interpreted a statute in a specific way, an administrative agency may not step in to change the court's interpretation through rulemaking.[202] In *Bankers Trust New York Corp. v. United States*, the Court of Appeals for the Federal Circuit explained:

> [W]e conclude that the Court of Federal Claims erred in holding that, on the facts of this case, an Executive agency regulation could effectively construe a statute in a manner different from a prior definitive court ruling. . . . The *Chevron* doctrine . . . is not in conflict with stare decisis . . ., which requires adherence to precedential decisions of this court and of our predecessor courts.[203]

The court must adhere to precedent interpreting the statute in the face of agency regulations to the contrary.[204]

B. Rule 10b5-2(b)(1) Analyzed Under Chevron

Under the first prong of the *Chevron* test, the court must look at the language of the statute under which the rule is promulgated to assess whether the statutory language is ambiguous.[205] Section 10(b) of the Exchange Act prohibits the use of a proscribed deceptive or manipulative device in connection with the purchase or sale of securities. In *Santa Fe Industries, Inc. v. Green*,[206] the Supreme Court explained that securities law takes a narrow definition of manipulation.[207] The Court explained that

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[198] Nat'l Ass'n of Home Builders v. Defenders of Wildlife, 551 U.S. 644, 665 (2007) (outlining the test created in *Chevron*).

[199] *See id.* at 655.

[200] *See* FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 132 (2000).

[201] *Chevron*, 467 U.S. at 844.

[202] *See* Bankers Trust N.Y. Corp. v. United States, 225 F.3d 1368, 1376 (Fed. Cir. 2000).

[203] *Id.*

[204] *See id.*

[205] *Chevron*, 467 U.S. at 842–43.

[206] 430 U.S. 462 (1977).

[207] *See id.* at 476.

"'[m]anipulation' is 'virtually a term of art when used in connection with securities markets.'"[208] The term manipulation refers only to activities "that are intended to mislead investors by artificially affecting market activity."[209] The Court went on to explain that this reading of the statute is based on the clarity of the language and the context of the statute.[210] This reading of the word manipulation makes it easy to see that trading while under a confidentiality agreement is not within this definition, which the Court sees as unambiguous in the language of the statute.

Deception has not been as clearly defined by the courts. In fact, in the context of deception, the Court recognized that "[s]ection 10(b) must be read flexibly, not technically and restrictively."[211] Even analyzing this broadly, to find liability under § 10(b), there must be deception in connection with the sale of a security. With this in mind, the Court explained that the statute requires that an individual must have a duty to disclose or abstain to be found liable.[212] In the context of the misappropriation theory, the trader must be part of a fiduciary or fiduciary-like relationship to find such a duty.[213] Without such a duty to disclose or abstain created under a fiduciary or fiduciary-like relationship, trading while in possession of the information is not deceptive.

The next question is whether a confidentiality agreement, on its own, creates a duty such that, by trading, the tippee has employed a deceptive device. If not, Rule 10b5-2(b)(1) overreaches the statutory authority of the SEC by creating liability under § 10(b) without the existence of deception or manipulation. It is unreasonable to interpret a promise not to disclose confidential information as a simultaneous agreement not to use that information (while keeping it confidential) for an individual's personal benefit. The acts of disclosure and use are temporally separate acts, and it would be perverse to believe that, when an individual agrees not to disclose a piece of information, it is inherently deceitful to use that information for his personal benefit while maintaining confidentiality.[214] This is especially

[208] *Id.* (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976)).

[209] *Id.* For a full discussion of the definition of the word manipulation in the context of securities law, see Daniel R. Fischel & David J. Ross, *Should the Law Prohibit "Manipulation" in Financial Markets?*, 105 HARV. L. REV. 503, 507–10 (1991) (explaining that, although there are several formulations of the definition of manipulation, they are all grounded in attempts to affect market pricing).

[210] *See Santa Fe Indus.*, 430 U.S. at 477.

[211] Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).

[212] *See* United States v. O'Hagan, 521 U.S. 642, 654–55 (1997); Chiarella v. United States, 445 U.S. 222, 230 (1980).

[213] *See O'Hagan*, 521 U.S. at 655.

[214] This Note ignores the argument that by trading, an individual may be disclosing the confidential information to the market. This may be true for a very large investor who gains confidential information and then subsequently purchases or sells large quantities of stock. This is not, on the other hand, an argument in favor of a blanket statement that trading while under a confidentiality agreement is deceitful. To look at the far other end of the spectrum, imagine an investor who only trades a single

true in the context of a market where individuals often agree to nonuse agreements on top of confidentiality agreements. Companies would not need nonuse agreements if, simply by agreeing to confidentiality, an individual was also agreeing not to trade while maintaining that confidentiality.

The Supreme Court, in *Ernst & Ernst v. Hochfelder*, explained that § 10(b) contains a scienter requirement.[215] The Court reasoned that although willful action was not expressly required in the language of § 10(b), when considered in the context of the negligence standard set in § 11, the legislative intent for willfulness was clear.[216] Considered in the context of the Supreme Court's assessment that scienter is required for § 10(b) liability, the clarity of deceit is even more evident. One might argue that without a scienter requirement in the statute, what constitutes a deceitful act could be vague. The requirement of willful, knowing, or purposeful conduct requires a narrow definition of what is deceitful. It is unrealistic to suggest that Congress could have intended a scienter requirement as the Court found in *Hochfelder*, but would then apply a broad definition of deceit such that trading after agreeing only to confidentiality would be included.

Assuming arguendo that 10b5-2(b)(1) is not contrary to the courts' interpretation of the meaning of the statute, the rule does not pass the second prong of the *Chevron* test: Rule 10b5-2(b)(1) is "arbitrary, capricious, or manifestly contrary to the statute."[217] One could argue that although the statute requires deception, it does not explicitly address the question of what types of relationships breed a duty that can lead to the requisite deception. Therefore, it would be within the province of the SEC to respond to this question. Even in that context, the relationships that the SEC does define must pass the second prong of the *Chevron* test. It flows from the argument above regarding the unambiguous language of the statute that including mere confidentiality agreements within this structure is manifestly contrary to the statute. A confidentiality agreement alone fails to create a situation where a deceptive act is possible by trading without some further fiduciary or fiduciary-like relationship. Therefore, whether Rule 10b5-2(b)(1) is assessed under the first or second prong, it is unrealistic that the rule could pass the *Chevron* test. The rule therefore does not deserve deference from the courts.

Even assuming that Rule 10b5-2(b)(1) is neither contrary to the unambiguous language of the statute nor manifestly contrary to the statute

share based on this information. It is impossible to claim that this act somehow discloses this information to the market and is therefore deceitful. Since this Note involves the overall validity of the Rule, it is irrelevant if, in some cases, disclosure would occur due to the trading because in those cases there clearly would be an act of deceit.

215 425 U.S. 185, 201 (1976).

216 *See id.* at 208.

217 *Chevron*, 467 U.S. at 844.

under the second prong, stare decisis prevents the courts from finding liability under 10b5-2(b)(1).[218] The Supreme Court's jurisprudence regarding § 10(b)—from *Chiarella* through *O'Hagan*—sets a clear standard—for § 10(b) liability, the court must find a fiduciary or fiduciary-like relationship.[219] The Supreme Court has, through these cases, explained how "deceptive" should be read in the context of § 10(b). Under *Chiarella*, the Court said that "[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak."[220] The Court explained that a breach of a fiduciary or fiduciary-like duty is required by the plain text of the statute.[221] The *O'Hagan* Court was also explicit in stating that the requirement for a fiduciary or fiduciary-like duty is grounded in the statute's text.[222]

Whether Rule 10b5-2(b)(1) could realistically make it past the *Chevron* test without precedent from the Supreme Court is unlikely. The unambiguous language of the statute requires deception that cannot be present when the only duty created is through a mere confidentiality agreement. Even if Rule 10b5-2(b)(1) were able to clear the hurdle of the *Chevron* test without the Supreme Court precedent to date, *Chiarella* and *O'Hagan* have already foreclosed the question of what type of relationship is necessary for proving deception under § 10(b). Therefore, Rule 10b5-2(b)(1) is an invalid use of the SEC's rulemaking power and reaches beyond the scope of § 10(b) of the Exchange Act. The rule cannot be used as the basis for § 10(b) liability for insider trading.

218 *See* Bankers Trust N.Y. Corp. v. United States, 225 F.3d 1368, 1376 (Fed. Cir. 2000).

219 *See supra* Part I (outlining the Supreme Court's history regarding the relationship requirements for § 10(b) liability).

220 445 U.S. 222, 235 (1980).

221 *See id.* at 234–35.

222 United States v. O'Hagan, 521 U.S. 642, 659 n.9 (1997); *see also* Regents of the Univ. of Cal. v. Credit Suisse First Bos. (USA), Inc., 482 F.3d 372, 389 (5th Cir. 2007) ("[T]he [Supreme] Court . . . has established that a device, such as a scheme, is not 'deceptive' unless it involves breach of some duty of candid disclosure."); SEC v. Dorozhko, 606 F. Supp. 2d 321, 335 (S.D.N.Y. 2008) (outlining that *O'Hagan* clearly states that § 10(b) "does not reach all structural disparities in information that result in securities transactions, only those disparities obtained by dint of a breach of fiduciary duty of disclosure"), *vacated*, 574 F.3d 42 (2d Cir. 2009). On appeal in *Dorozhko*, the court explained that there may be a situation in which a fiduciary or fiduciary-like relationship is not required for § 10(b) liability. *See* 574 F.3d at 48. This situation is when there is direct deception in the act of obtaining the information, rather than where there is a duty to disclose or abstain. *See id.* at 50. Since there is clearly direct fraud in that type of situation, the court does not need to take the extra step of identifying whether a duty exists to establish a violation. *See id.* This is not inconsistent with the argument in this Note because the appellate court did confirm in its discussion that, in a disclose-or-abstain situation, a fiduciary or fiduciary-like duty is still necessary. *See id.*

V. The Future of Insider Trading Liability Based Exclusively on a Mere Confidentiality Agreement—What Is Realistic?

Now that the Fifth Circuit Court of Appeals in *Cuban* has vacated the motion to dismiss and remanded for discovery and trial,[223] it is unlikely that this case will be an opportunity for the Supreme Court to face the question of the scope of liability under § 10(b). However, it is imperative that the Court respond to the SEC's post-*O'Hagan* rulemaking and clarify whether Rule 10b5-2(b)(1)[224] is a valid use of the SEC's rulemaking power. Without clarification from the Supreme Court, the question of the applicability of § 10(b) liability to confidentiality agreements is a likely source of a future circuit split regarding whether these rules are appropriate uses of the SEC's rulemaking power. When such a split occurs, it is essential that the Court clear up this issue because predictability is essential in the context of securities law to promote efficient markets.

For the sake of clarity, Congress should also take action to elucidate the intent of § 10(b) in the context of insider trading, although this is very unlikely to happen in the near future. As the SEC's insider trading enforcement becomes more complicated in the post-*O'Hagan* era, the simple definition Congress provided in § 10(b) is no longer sufficient to provide direction for both the SEC and the courts. As trading strategies and technology grow more complicated, the basic idea of a company officer going behind the back of the corporation, disregarding his fiduciary duty, and trading for his personal benefit is no longer the archetype of insider trading.

Unfortunately, it is unlikely that Congress will take this approach. The inevitable minefield that comes with either position on this issue makes it so politically sensitive that the legislature will likely allow the SEC and the courts to reach a solution. By taking the position that a confidentiality agreement is not sufficient grounds for insider trading liability, a congressman could be perceived as supporting elite individuals who, short of a fiduciary relationship, are able to obtain access to information that an average trader would never be able to obtain. On the other hand, by strengthening insider trading law and extending regulations to cover such a relationship, a legislator could also anger powerful constituents with the wealth and influence to gain the type of information that Cuban was able to obtain. Realistically, it is a no-win situation for any legislator and is therefore unlikely to ever be introduced by a member of Congress, let alone make it out of committee.

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[223] SEC v. Cuban, 620 F.3d 551 (5th Cir. 2010).

[224] Rule 10b5-1 and the remainder of Rule 10b5-2 have also been questioned as to their validity under § 10(b). For a discussion of the validity of Rule 10b5-1, see Allan Horwich, *The Origin, Application, Validity, and Potential Misuse of Rule 10b5-1*, 62 BUS. LAW. 913, 943–49 (2007).

The broader question that must be asked is what should be the appropriate scope of § 10(b) liability in the context of confidentiality agreements. Some top economists have suggested that insider trading law should be far less restrictive than the current law. Arguments include the promotion of strong market efficiency and the administrative costs associated with insider trading enforcement. Many even claim that insider trading impacts the market positively by bringing information to the surface more quickly.[225] Milton Friedman, laureate of the Nobel Memorial Prize in Economics, said: "You want more insider trading, not less. You want to give the people most likely to have knowledge about deficiencies of the company an incentive to make the public aware of that."[226]

Despite the possible benefits of insider trading to the market,[227] this Note focuses exclusively on why the prohibition on insider trading should not be extended to mere confidentiality agreements. As established early in this Note, the intent of § 10(b) is to promote full disclosure of inside information for the protection of the average investor and to promote fair dealing in securities trading.[228] The goal of the statute is to protect the average securities trader and to promote honesty in the securities market. In evaluating this issue, one must be conscious of the balance that any approach would have on the honesty of the securities market with the broader impact that it could have on the securities markets as a whole.

It is generally accepted in modern economics that market liquidity is an essential aspect of modern financial markets.[229] Although it would be extreme to suggest that a rule extending insider trading liability to relationships born merely out of a confidentiality agreement would have a considerable impact on the liquidity of securities markets, it is also unrealistic to think that it would have no impact. The individuals trading large quantities of securities on the markets are often the same people with access to the types of material nonpublic information that Cuban did. With the extension of insider trading law to these types of relationships, it is a valid fear that this may induce a trend toward excessive enforcement on any trading done with knowledge of material nonpublic information. Once the current requirement for deception falls off the table, an investor is

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[225] *See, e.g.*, James Altucher, *Should Insider Trading Be Made Legal?*, HUFFINGTON POST (Oct. 20, 2009, 6:51 PM), http://www.huffingtonpost.com/james-altucher/should-insider-trading-be_b_324409.html (suggesting that while insider trading should be illegal, there could be benefits from legalization).

[226] Interview by Michelle Caruso-Cabrera with Milton Friedman, *Power Lunch: Trust Markets to Weed Out Corporate Wrongdoers* (CNBC television broadcast Mar. 12, 2003).

[227] For a discussion of some of the arguments for legalizing the practice, see MANNE, *supra* note 26, at 235–255.

[228] *See* Williams, *supra* note 25, at 411–12.

[229] For a general overview of the role that market liquidity plays in financial markets, see Timothy F. Geithner, Liquidity and Financial Markets, Keynote Address at the 8th Annual Risk Convention and Exhibition, Global Association of Risk Professionals, New York City (Feb. 28, 2007), *available at* http://www.newyorkfed.org/newsevents/speeches/2007/gei070228.html.

inevitably going to be afraid to trade any time he has this type of information. Therefore, the impact to market liquidity could be substantial.

In this context, weighing the potential positive impact toward honesty in the market against the potential negative impact to the securities market, it seems clear that the better option is to maintain the current line by requiring deception for § 10(b) liability. It is, realistically, a small number of people who have a confidentiality agreement in place without any further relationship that creates the fiduciary or fiduciary-like relationships required by *Chiarella* and *O'Hagan*. Therefore the extension of insider trading liability to these individuals would have a minimal impact on market honesty. On the other hand, the impact that sending such a message could have on the willingness of individuals with access to material nonpublic information to trade, even when such trading would not be deceptive, could have a noticeable impact on market liquidity. This is a harm far outweighing the minor constructive impact.

So what is the realistic future of insider trading liability under § 10(b) based solely on a confidentiality agreement? Legislative action by Congress to clarify the scope of the law would be the best course of action; however, for the reasons above, this solution is unlikely. Instead, the SEC will continue to push the bounds of § 10(b) enforcement and will potentially create a disparate set of case law in the lower courts until the Supreme Court chooses to take on this issue. It is only for time to tell whether the Supreme Court will find it appropriate to provide a wide enough berth of deference to the SEC to sustain the validity of Rule 10b5-2(b)(1).

CONCLUSION

Liability under § 10(b) of the Exchange Act should not extend to relationships based solely on a confidentiality agreement. To date, the Supreme Court's insider trading jurisprudence requires a fiduciary or fiduciary-like duty that is not created by a simple agreement to keep information confidential. The SEC attempted to circumvent these rulings by enacting Rule 10b5-2(b)(1) in 2000, but this rule reaches beyond the scope of the SEC's rulemaking power under § 10(b) and should not be afforded *Chevron* deference by the courts. Further, the extension of liability to such relationships would create more negative consequences for securities markets than have a positive influence on market honesty. Whether it ends up being the legislature or the courts that have the final say on whether these relationships are sufficient for liability, this is not an issue that is likely to go away any time soon.