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O’HAGAN, 10b5-2, RELATIONSHIPS AND DUTIES

Thomas M. Madden, J.D.*

INTRODUCTION

In the past ten years, the law regarding insider trading has been marked by two principal events: the Supreme Court’s O’Hagan decision handed down in 1997, and the Commission’s modification of Rule 10b-5 effected at the turn of the millennium by SEC Release 33-7881. Now, seven years after the creation of Rules 10b5-1 and 10b5-2, we wonder what have these rules done to O’Hagan? Specifically, what has Rule 10b5-2 done to the consideration of relationships giving rise to duties of trust and confidence?

The answer to this question goes principally to the policy motivations of the Commission. Who is the Commission going after and why—both in terms of rulemaking and enforcement? Is the Commission seeking to generally promote fair and efficient trading upon current, accurate, well disbursed information; or, is it targeting submarkets where the boundaries of conventional trading are being pushed—in state of the art hedging, in PIPES (where public trades are made with knowledge of looming high risk

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3. PIPES, “Public Investments in Private Equity”, are investments made often by hedge fund managers in companies about to go public via reverse mergers into languishing public “shells”. See Bruce Hiler, Tom Kuczajda & Anne Marie Helm, Enforcement PIPEline: Insider Trading, Unregistered Sale, and the Hedging of Private Investments with Public Equity, 39 SEC. REG. & LAW 952 (June 18, 2007).
would-be initial public offerings), and where dealmaker relationships may constitute a market bifurcated from individual investors and the lesser informed?

I. MISAPPROPRIATION AND O'HAGAN, CIRCA 1997

In its nascent stages, what became a Supreme Court doctrine in 1997, was the S.E.C.'s theory advanced in Matter of Cady, Roberts & Co.\(^4\) and expanded in 1980 in then Chief Justice Burger's dissent from the majority in Chiarella v. United States.\(^5\) \(^6\) The "misappropriation theory," as enunciated in Justice Ginsburg's majority opinion handed down in June of 1997 in United States v. O'Hagan,\(^7\) was hardly the birth of consensus on SEC policy governing insider, quasi-insider and outsider trading.\(^8\) It was, however, the direct address by the nation's highest court of an issue of longstanding contention among scholars, practitioners, the federal judiciary, and vicariously, anyone else interested in federal securities law and fair and efficient public securities markets.

A. BEFORE O'HAGAN

Burger's 1980 conception of section 10(b)\(^9\) of the Securities Exchange Act of 1934\(^10\) (the "Exchange Act") and Rule 10b-5\(^11\) promulgated

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6. Note, however, that as Justice Ginsburg asserts, the form of the misappropriation theory adopted in O'Hagan is not the same as that advocated by Chief Justice Burger in his Chiarella dissent. See O'Hagan, 521 U.S. at 655 n.6. In O'Hagan, "the disclosure obligation runs to the source of the information" Burger would have had it run "to those with whom the misappropriator trades." Chiarella, 445 U.S. at 240.
8. See Ralph Ferrara, FERRARA ON INSIDER TRADING AND THE WALL, § 2.02 [6][a] for an overview of the misappropriation theory in the context of § 10(b) and Rule 10b-5 fraud precedent.
9. It shall be unlawful "To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device in contravention of such rules and regulations as the Commission may prescribe as necessary of appropriate in the public interest or for the protection of investors."
11. Rule 10b-5 states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or
thereunder by the Securities and Exchange Commission (the "Commission") was broad and policy oriented. It was written in contrast to Justice Powell's narrowly tailored majority decision in Chiarella finding that a fiduciary duty must exist and be breached and that that breach must touch the party to the transaction to whom the duty is owed; "liability [under section 10(b) and Rule 10b-5] is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." Powell's majority refused to uphold a lower court ruling holding Chiarella liable for trading based upon information about the proposed takeover of a client of his printing firm employer which he had gathered in the course of his employment. The Chiarella Court held that "a duty to disclose does not arise from the mere possession of non-public market information and noted that as a matter of policy, we should not discourage the acquisition of market information." Burger dissented. He thought, on the other hand, that Chiarella's conviction by the lower court should be upheld. In his dissent, Burger laid the groundwork for the adoption of the misappropriation theory. He wrote:

I would read § 10(b) and Rule 10b-5 to encompass and build on this principle: to mean that a person who has misappropriated non-public information has an absolute duty to disclose that information or to refrain from trading." Moreover, he emphasized that "by their terms these [ section 10(b) and Rule 10b-5] provisions reach any person engaged in any fraudulent scheme. This expansive conception of the "disclose or abstain rule" would create a basis of section 10(b) and Rule 10b-5 liability that could easily encompass the 1997 version of the misappropriation theory.

In his Chiarella dissent, Burger looked to Cady, Roberts & Co. and the general policy of securities laws to assure fairness among investors. In Cady, Roberts, a broker-dealer who was a director of an issuer in which the broker-dealer traded, passed on information about the issuer to a colleague who traded in the issuer's securities based upon that information about an hour before the information became public. In Cady, Roberts, the Commission reasoned that it cannot "accept respondents' contention that an

sale of any security.

17 C.F.R. § 240.10b-5. Generally, there are five elements required to establish a claim under Rule 10b-5: (1) fraud (including materiality, reliance, causation and damages) or deceit, (2) by a person, (3) in connection with, (4) the purchase or sale, (5) of any security. See Hazen, THE LAW OF SECURITIES REGULATION, Ch. 13 for an overview of the elements of Rule 10b-5.

14. Id. at 235.
15. Id. at 240.
16. Id.
Insider's responsibility is limited to existing stockholders and that he has no special duties when sales of securities are made to non-stockholders. The Cady, Roberts court adopted a "parity of information" approach, reasoning that those with nonpublic information should not profit at the expense of those in the market without that information, again referring only to purchasers or sellers. The Commission's language in Cady, Roberts had the effect of extending protection to the buying public, but only to those actually purchasing securities. Burger would extend this fraud protection to the general buying public, including merely potential buyers.

B. O'HAGAN

Ginsburg's O'Hagan decision overturned the Eighth Circuit's reversal of a trial court criminal conviction of a lawyer working for a firm representing a client contemplating a tender offer to take over a target company. O'Hagan was a lawyer at Dorsey & Whitney who learned of a client's takeover plan through work at his firm. He traded in securities of his client's target company, not his client, based upon the information he learned through working at his firm and, consequently, profited by several million dollars. The S.E.C. brought suit against O'Hagan under section 10(b) of the Exchange Act and Rule 10b-5.

Ginsburg's majority opinion in O'Hagan was reasoned from the Commission's approach taken in Cady, Roberts and the extension of that approach by Burger in his Chiarella dissent. Early in her opinion, Ginsburg set out the policy argument behind the O'Hagan decision: "Because undisclosed trading on the basis of misappropriated, nonpublic information both deceives the source of the information and harms members of the investing public, the misappropriation theory is tuned to an animating purpose of the Exchange Act: to ensure honest markets, thereby promoting investor confidence."22 This broad policy directive easily envelops an extended reading of section 10(b) and Rule 10b-5.

Ginsburg's use of the misappropriation theory in her majority opinion

20. Id. at 914.
in O'Hagan focused on the theory's elements of fraud and deception which the lower court found lacking.\footnote{23. United States v. O'Hagan, 92 F.3d 612 (8th Cir. 1996).} She cites \textit{Santa Fe Industries, Inc. v. Green}\footnote{24. Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977).} to make the point that the misappropriation theory correctly applies section 10(b), not as a general ban on breaching fiduciary duty\footnote{25. \textit{Id.} at 473.} but as a more specific prohibitor of manipulation and deception.\footnote{26. \textit{Id.} at 475-77.} (Under the facts of \textit{Santa Fe}, after management's full disclosure of formerly nonpublic information regarding the use of the Delaware statutory short form merger, none of the manipulation or deception alleged by the minority shareholders was found present). But the case from which Ginsburg derives the crux of her argument adopting the misappropriation theory is \textit{Carpenter v. United States}.\footnote{27. \textit{Carpenter v. United States}, 484 U.S. 19 (1987).}

1. Misappropriation Theory Precedent

Before delving into \textit{Carpenter}, we should note that \textit{Cady, Roberts}\footnote{28. \textit{See also}, S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969) where the Second Circuit adopted the “parity of information” approach found in \textit{Cady Roberts}.} and \textit{Chiarella} are the two key cases in tracking the origin of the misappropriation theory. We've discussed the two key cases in terms of their relevance to the theory and to the development of section 10(b) and Rule 10b-5 fraud liability generally in the preceding section.

In \textit{Carpenter}, an investment advice columnist disclosed nonpublic information about issuers which was prohibited to be disclosed by his publisher/employer and went on to share in the profits gained by his tippees who traded based on the nonpublic information. \textit{Carpenter} offers a discussion of fraud regarding a property right; that is, the publisher/employer's property interest in the nonpublic information. Winans, the tipping columnist in \textit{Carpenter}, (and his tippees) were found guilty by the lower court of mail and wire fraud\footnote{29. 18 U.S.C. §§ 1341, 1343 and conspiracy 18 U.S.C. § 371.} and of violating section 10(b) of the Exchange Act. The Supreme Court upheld the section 10(b) decision without discussion because the Court was evenly split on the issue. The Court gave its reasons for upholding the mail and wire fraud decision—finding that the fraud was committed against the publisher/employer who held the property interest in the nonpublic information. The lower court reasoning on the section 10(b) issue, which the Supreme Court accepted by default, was that the same fraud on the
publisher/employer was a violation of section 10(b) and Rule 10b-5 because that fraud was "in connection with" a purchase or sale of securities—even though that purchase or sale did not involve the defrauded publisher/employer.

In Carpenter, then, the court did not require that the fraud element in the section 10(b) and Rule 10b-5 violation be on the shareholders of the company about which the nonpublic information was known. It was enough that a fraud was broadly "in connection with" the purchase and sale of securities. It is this broadened reading of Rule 10b-5, harkening back to Burger's Chiarella dissent and the earlier Cady, Roberts decision, that allowed the misappropriation theory to work for Ginsburg.

Ginsburg wholeheartedly adopted a broad reading, notwithstanding her disclaimer that she had not adopted the sweeping rule proposed by Burger in his Chiarella dissent. Indeed, in the first paragraph of her opinion, Ginsburg frames the section 10(b) issue as follows: "Is a person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, guilty of violating § 10(b) and Rule 10b-5?" The very way she frames this issue precludes following the approach set out by Powell in his majority opinion in Chiarella. Ginsburg framed the issue with a particular (fraud on the source) version the misappropriation theory already tacitly adopted.

The facts of O'Hagan make this issue framing determinative of the case's outcome. As mentioned, O'Hagan was a lawyer for a firm representing a company in matters preliminary to making a tender offer for a target company. During that representation, he learned the nonpublic information of the client's tender offer plans to acquire the target company. He then traded in the client's target's securities based upon that nonpublic information to his significant profit.

If the Court in O'Hagan followed the Chiarella majority, the issue would be: is a person who uses nonpublic information to trade in securities for personal profit guilty of violating section 10(b) and Rule 10b-5 even though he has no fiduciary duty to any party to the purchase or sale of the securities in which he trades? Obviously, this framing of the issue would not have lead to the Court's decision.

In a 1981 opinion, U. S. v. Newman, the Second Circuit applied the misappropriation theory, making specific references to both Stevens' and

31. See supra note 3
Burger's dissents in Chiarella. The Newman court relied mainly on Second Circuit precedent in asserting that "long before appellee undertook to participate in the fraudulent scheme alleged in the indictment, this court, and other courts of appeals as well, had held that a plaintiff need not be a defrauded purchaser or seller in order to sue for injunctive relief under Rule 10b-5." The court simply accepted the facts (that insider investment bank employees repeatedly tipped off Newman about upcoming takeovers of the investment banks' clients and Newman regularly directed conspirators to execute foreign trades based upon that nonpublic information over a period of several years) as establishing fraud and deceit—relying, inter alia, on Burger's Chiarella dissent. The crux of the court's reasoning lies in its statement that "since appellee's sole purpose in participating in the misappropriation of confidential takeover information was to purchase shares of the target companies, we find little merit in his disavowal of a connection between the fraud and the purchase." Again, under the duty to the source version of the misappropriation theory, the fraud tied to the fiduciary duty need not involve the shareholders of the company in whose securities the trades are made.

In S.E.C. v. Materia, the Second Circuit repeated its approach taken in Newman. The facts in Materia were most similar to those in Chiarella. An employee of a financial printer misappropriated nonpublic information from his employer about pending tender offers and used that information to trade in the securities of the tender offer targets to his substantial profit. The Materia court found obvious fraud and deceit and as in Newman held: "one who misappropriates nonpublic information in a breach of a fiduciary duty and trades on that information to his own advantage violates Section 10(b) and Rule 10b-5." The court ultimately looked to the policy behind the Exchange Act, the insurance of fair and efficient public securities markets, calling that policy the "lodestar" on which its decision relies.

The alternative to the misappropriation theory is the "classical theory," and the two are not necessarily mutually exclusive. The "classical" standard of a violation of Rule 10b-5 is clearly set out as dicta

34. Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969); Mutual Shares Corp. v. Genesco Inc., 384 F.2d 540 (2d Cir. 1976).
36. Id. at 18.
38. Id. at 203.
39. Id.
40. For further precedent within the Second Circuit, see also United States v. Willis, 737 F. Supp. 269 (S.D.N.Y. 1990) (breach of a relationship of a psychiatrist with the wife of a businessman was enough to find Rule 10b-5 liability when the psychiatrist traded in securities of a corporation involving the businessman/husband based on the nonpublic information revealed to him by the patient/wife, which information she had learned from her husband), SEC v. Musella, 578 F. Supp. 425 (S.D.N.Y. 1984) (where tippees of an administrative law firm employee inherited duty not to trade from tipper).
A person violates Rule 10b-5 by buying or selling securities on the basis of material nonpublic information if (1) he owes a fiduciary or similar duty to the other party to the transaction; (2) he is an insider of the corporation in whose shares he trades, and thus owes a fiduciary duty to the corporation's shareholders; or (3) he is a tippee who received his information from an insider of the corporation and knows, or should know, that the insider breached a fiduciary duty in disclosing the information to him.\(^{42}\)

The classical theory, as so stated, is actually an agglomeration of precedent finding insiders and tippees, or quasi-insiders, guilty of violating Rule 10b-5. It is not a theoretical construct, but the result of case law applying Rule 10b-5 to a series of discrete facts. While the classical theory applies insiders and tippees, or quasi-insiders, the misappropriation theory may apply further to "outsiders." The misappropriation theory is a theoretical tool constructed from the Commission's/government's arguments asserting Rule 10b-5 coverage over "outsiders," not just insiders and quasi-insiders.

The classical definition could not fit the facts of *Clark* where Clark was found to be neither an insider nor a tippee and consequently had no relevant duty to disclose or abstain from trading in certain securities on the basis of nonpublic information.\(^{43}\) Clark was the principal of a recently acquired company and learned from a colleague on the parent company's acquisition team that the acquirer was going to make another acquisition. Subsequently, Clark traded in the stock of the parent's potential target to his significant profit.

The *Clark* court went on to adopt the misappropriation theory, stating,

Unlike the classical theory, the misappropriation theory extends to trading by outsiders. Generally speaking, the theory provides that Rule 10b-5 is violated when a person (1) misappropriates material nonpublic information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock.\(^{44}\)

Under the broader misappropriation theory, the court was able to find that Clark, as an outsider, violated of Rule 10b-5. He had no fiduciary duty to the company or shareholders of the takeover target, was not a tippee who knew that his tipper had such a duty, but still was found to have violated Rule 10b-5.

\(^{41}\) S.E.C. v. Clark; 915 F.2d 439 (9th Cir. 1990).
\(^{42}\) *Id* at 443.
\(^{43}\) *Id*.
\(^{44}\) *Id*.
The *Clark* court went on to justify its broader reading by looking to the adoption of the rule and to the legislative history surrounding the securities law and noted that Rule 10b-5 was intended to be a "catchall" for fraud in securities trading.\textsuperscript{45} Yet, even though the court consciously adopted a broader reading of Rule 10b-5 than any Supreme Court precedent allowed, it was a qualified reading. The *Clark* court noted, "[t]he misappropriation theory, as we have adopted it today, applies only where the misappropriation occurs by means of a violation of fiduciary or some similar duty."\textsuperscript{46} That duty did not have to be to the shareholders of the company in whose shares the violating trades were conducted. Moreover, that duty, which was limited factually in *Clark* as one arising from employment, it was noted by the court, need not be express.

In *S.E.C. v. Cherif*\textsuperscript{47} the Seventh Circuit adopted the misappropriation theory following the Ninth Circuit's "common sense notion of fraud" applied in *Clark*.\textsuperscript{48} Cherif had terminated his employment at a bank, but retained access to his former employer's place of business. He used that access to obtain nonpublic information from his former employer and conducted securities trades based upon it. The Seventh Circuit reasoned that the breach of a fiduciary duty arising from employment, even if owed to a past employer, was enough to apply Rule 10b-5. The *Cherif* court concerned itself with the breach of a fiduciary duty owed to the source of the nonpublic information; "[t]he misappropriation theory focuses not on the insider's fiduciary duty to the issuing company or its shareholders but on whether the insider breached a fiduciary duty to any lawful possessor of material nonpublic information."\textsuperscript{49} Thus, the *Cherif* court's application gave us a slightly broader version of the misappropriation theory than did the *Clark* court.

Both *Clark* and *Cherif* give us the approach necessary to use the misappropriation theory. The court must simply look to the breach of a fiduciary duty owed to the source of the information in order to find Rule 10b-5 liability. This, again, is the approach taken in Ginsburg's initial framing of the issue at the outset of her *O'Hagan* opinion and is the law as a result of the Supreme Court's adoption of her majority opinion. After *O'Hagan*, the fraud at issue in a Rule 10b-5 violation no longer had to be tied to the fiduciary duty owed to shareholders, whether actual or potential buyers, in a traded company's securities.

The Second Circuit applied the misappropriation theory in *U.S. v.*

\textsuperscript{45} Id. at 448
\textsuperscript{46} Id. at 453. (emphasis added)
\textsuperscript{47} S.E.C v. Cherif, 933 F.2d 403 (7th Cir. 1991).
\textsuperscript{48} Id. at 410.
\textsuperscript{49} Id. at 409.
In Chestman, the theory was expanded beyond the employment relationship as the source of the fiduciary duty affected by the fraud covered under Rule 10b-5, even though such a duty was eventually not found present in the facts of the case. Chestman was a broker who traded in an issuer's stock after his client phoned him with nonpublic information that the issuer was shortly to be acquired for more than its current trading price.

Chestman's tipper was a client who learned of the information through marriage to a woman whose family owned a significant amount of equity of the company involved in the planned acquisition and included members of the board of directors. The broker, Chestman, used the information to trade for his client's (the husband's) account and was originally convicted of violating Rule 10b-5 as an aider and abettor to the husband. The Chestman court spent several pages discussing the nature of fiduciary duty and focused on the "relationship of trust or confidence" at the heart of the duty. The essential element in the duty is reliance. After extensive discussion of fiduciary duty and consideration of the possible implied duty of the husband to the family owned corporation not to disclose the nonpublic information, the court found that such a duty was not present because there was no prior aspect of the relationship that would establish such an implied duty. Thus, the aiding and abetting link to Chestman was meaningless and the Rule 10b-5 claims against Chestman were overturned.

Prior to O'Hagan, the most recent decision on the misappropriation theory was an emphatic rejection of the theory handed down by the Fourth Circuit in U.S. v. Bryan. The misappropriation theory as adopted by the Second, Seventh and Ninth Circuits, was well defined by the Bryan court as consisting of four elements: (1) misappropriation of material nonpublic information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) using that information in a securities transaction, (4) regardless of whether [one owes] any duties to the shareholders of the traded stock.

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51. Id. at 568. (emphasis added)
52. Id.
The *Bryan* court repudiated the misappropriation theory in a fact pattern where the director of the West Virginia state lottery traded in the securities of companies with whom the state lottery was doing business. During the course of his employment as director, Bryan was privy to nonpublic information about increased business the lottery would give these companies. The *Bryan* court, in finding no section 10(b) liability, noted that Bryan had no fiduciary duty to the companies in which he traded, nor to their shareholders.

The *Bryan* court's view of the misappropriation theory in relation to the history of section 10(b) and Rule 10b-5 and precedent thereon is most clear here:

Section 10(b) ... prohibits only the use of deception, in the form of material misrepresentations or omissions, to induce action or inaction by purchasers or sellers of securities, or that affects others with a vested interest in a securities transaction. In contravention of this established principle, the misappropriation theory authorizes criminal conviction for simple breaches of fiduciary duty and similar relationships of trust and confidence, whether or not the breaches entail deception within the meaning of Section 10(b) and whether or not the parties wronged by the breaches were purchasers or sellers of securities, or otherwise connected with or interested in the purchase or sale of securities. Finding no authority for such an expansion of securities fraud liability—indeed, finding the theory irreconcilable with applicable Supreme Court precedent—we reject application of the theory in this circuit.\(^5\)

As the *Bryan* court clearly sets out, the fraud on the source version of the misappropriation theory radically alters the prior standard for conviction under section 10(b).

2. More on the “Classical Theory”

The *O’Hagan* Court’s adoption of the government’s term “Classical Theory” more accurately denotes a loose composite of various precedent on Rule 10b-5 liability including liability found for categories of insiders, tippers and tippees or quasi-insiders.

In *Blue Chip Stamps v. Manor Drug Stores*\(^6\) the Supreme Court, in Justice Rehnquist’s majority opinion, gave us the rule that a private action

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\(^5\) *Bryan*, 58 F.3d at 944.

under Rule 10b-5 can apply only to actual purchasers or sellers of securities. In *Blue Chip*, an offeree alleged that an issuing company issued a false and misleading prospectus to him and other shareholders for an offering made subsequent to the reorganization. The Court looked to the Second Circuit's *Birnbaum* Rule which provides that private actions under Rule 10b-5 are limited to purchasers and sellers of securities. In a policy discussion, the Court considered the strike suit potential that could arise if private rights of action were expanded. The Court further considered the analogous common law of the tort of deceit before deciding that the weight of the policy issues favored upholding the *Birnbaum* Rule. The Court thus held that the offeree or offerees as a class were not entitled to sue for a violation of Rule 10b-5. This "Classical" holding clearly could not be relied upon to support the adoption of the misappropriation theory.

In *Ernst & Ernst v. Hochfelder* the Supreme Court addressed Rule 10b-5 via an issue of aiding and abetting liability. In *Ernst & Ernst*, an accounting firm failed to detect fraudulent escrow accounts at a securities firm which could have been uncovered by deeper inquiry into an unusual "mail rule" regarding the accounts. In Powell's majority decision, the Court held that negligent conduct was not enough but that scienter must be present in the alleged aider or abettor's actions in order to find civil liability attached to Rule 10b-5 fraud. Ultimately, the Court found that because the accountants were merely negligent in their duties, they were not liable for the fraudulent accounts under Rule 10b-5. A similar holding was issued in *Central Bank*.

In *Dirks v. S.E.C.* the Supreme Court held that a tippee officer of a broker-dealer who received information from an insider that an insurance company's stock would soon plummet in value, and then traded in the insurance company's stock based upon that information, was not liable of a Rule 10b-5 violation. The Court reasoned that the duty of a tippee is derivative and thus a breach or fraud occurs by the tippee only where a prior breach of a fiduciary by the insider/tipper to his employer's shareholders occurs. The Court looked to *Chiarella* to find the rule that there can be no duty to disclose where the person who has traded on inside information "was not [the corporation's] agent, ... was not a fiduciary, [or]"

57. *Id.* at 726.
60. *Id.* at 740-9.
61. *Id.* at 755.
63. *Id.* at 190.
64. *Id.* at 214.
was not a person in whom the sellers [of the securities] had placed their trust and confidence." The Court added that "[i]mposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the S.E.C. itself recognizes is necessary to the preservation of a healthy market." No fiduciary relationship was found which would give rise to the duty. Repeatedly, the Court, in Powell's majority decision, emphasized that the tippee's, or as used herein, the "quasi-insider's" duty is not nonexistent, but is derivative of the duty held by the tipper. As there was no breach of fiduciary duty by the tipper, the tippee inherited no derivative breach. However, the Dirks decision does not renounce any tippee duty giving rise to Rule 10b-5 liability. To the contrary, it forcefully recognizes the categories of tipper and tippee liability.

In Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A. the Supreme Court again considered aiding and abetting status under section 10(b). An appraiser of land which was collateral for a bond issue was accused of fraudulently inflating land values and consequently violating section 10(b). The bond issues' indenture trustee, the bank that hired the appraiser and delayed review of the potentially inaccurate appraisal, was accused of aiding and abetting the appraisal fraud, also violating section 10(b). After looking to Ernst & Ernst, Santa Fe, and Chiarella, Justice Kennedy, in a majority opinion for the Court, wrote, "[o]ur consideration of statutory duties, especially in cases interpreting section 10(b), establishes that the statutory text controls the definition of conduct covered by section 10(b)." That language does not include aiding and abetting. The Court added that aiding and abetting is not even "indirect liability" which is statutorily covered under section 10(b).

With regard to general section 10(b) liability, the Central Bank Court pronounced that

[a]ny person or entity, including a lawyer, a accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met.

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66. Id. at 654.
67. Id. at 658.
68. Id. at 659.
71. Central Bank, at 175.
72. Id.
73. Id. at 176.
74. Id. at 191.
Note that the *Central Bank* Court’s “classical” approach does not move liability beyond the breach of a fiduciary duty to purchasers or sellers involved in the securities transaction as the misappropriation theory would allow.

As the *Blue Chip*, *Ernst & Ernst*, and *Central Bank* decisions taken together indicate, “Classical Theory” precedent is somewhat lacking in uniformity. Generally, it requires, in great distinction to the misappropriation theory, the breach of a fiduciary duty to shareholders involved in the securities transaction. The duty can be simply that of an insider employee or can be one inherited from an insider by a tippee or quasi-insider. As the dicta from *Central Bank* points out, inherited duties can give rise to liability among lawyers, accountants and bankers, among others. However, no “outsider” could be found liable of violating section 10(b) or Rule 10b-5 under the “classical” precedent.

3. The Classical – Misappropriation Theory Dichotomy and Outsider Trading Liability

Ginsburg’s *O’Hagan* opinion appears to rely heavily on the case’s Brief for the United States. She embraces the government’s presentation of a dichotomy between “classical” and “misappropriation” approaches to determining section 10(b) and Rule 10b-5 liability and argues for the misappropriation theory. This unqualified endorsement of the fraud on the source version of the misappropriation theory leaves her with the adoption of outsider trading liability. After *O’Hagan*, there is no longer simply insider trading or even quasi-insider (tippee) trading liability: there is outsider trading liability.

A. Brief for the United States

Ginsburg cites the brief for the United States to emphasize the distinguishing element in the two theories: in the classical theory, the fiduciary duty at issue is owed to the shareholders of the corporation about which material nonpublic information which, based upon circuit court precedent, can include property based relationships at the center of duties owed to employers, former employers, and possibly family members or others.\(^75\), \(^76\)

She follows the government’s presentation of the deception involved

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\(^75\). United States v. Chestman, 947 F.2d 551 (2d Cir. 1991).
\(^76\). Brief for United States, O’Hagan No. 96-842, LEXIS 14.
in *O'Hagan*, accepting it at face value. That a lawyer would trade on nonpublic information is to be construed almost facially as deceiving to the source of the information. As Ginsburg quotes from the Brief for the United States, "[T]he misappropriation theory is thus designed to 'protec[t] the integrity of the securities markets against abuses by "outsiders" to a corporation who have access to confidential information that will affect the[e] corporation’s security price when revealed, but owe no fiduciary duty to that corporation’s shareholders.'" Under the adopted theory, the deception lies in the false loyalty to the source of the information which is betrayed upon the sharing of that information, presumably with one who initiates a securities trade based upon that information.

The "in connection with" element is satisfied under the theory when, without disclosure to the source of his information, the misappropriator trades. In great contrast to the classical approach, it does not matter whether the other party or parties to the trade are in any way deceived or touched by the fraud.

"The purchase and sale of any security" is read with an emphasis on the "any." This last element is expanded in the government’s brief with the rationale that "[s]ection 10(b) authorizes the SEC to prohibit deceptive devices as necessary or appropriate in the public interest or for the protection of investors." The government goes on to argue that the SEC is authorized to and (implicitly) should "prohibit deceptive acts that, it concludes, would have a deleterious effect on the integrity of the securities markets, even if the deception is not practiced directly on the person on the other side of the securities trade."

**B. Statutory and Regulatory Redress**

The Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA) was an attempt to address the concerns discussed here through a modification of the Exchange Act. The ITSFEA’s section 20A (15 U.S.C. 78t-1), added in 1998, created a cause of action against anyone violating the Exchange Act "by purchasing or selling a security while in possession of material, nonpublic information" for the benefit of anyone who "contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased or sold securities of the same class." It thus expanded civil liability over "controlling persons." However, it was two years later that the Commission adopted Rules 10b5-1

and 10b5-2; and it is under the latter rules that case law in the O'Hagan line has continued to address securities fraud with the fraud on the source version of the misappropriation theory.

If we were to decide the issue presented in O'Hagan by looking to precedent confined to the classical theory cases discussed supra, there would be no doubt that the O'Hagan Court had overstepped its bounds and created a new doctrine of law from whole cloth. Moreover, if we were to decide the same issue presented in O'Hagan by considering the classical theory cases together with the pre-O'Hagan misappropriation theory cases, it is not entirely clear that we should not come away with that same conclusion. Indeed, we would be hard pressed to overlook the admonition of the Fourth Circuit in Bryan. It must be emphasized, however, that this is not to say that the behavior of O'Hagan, and similar behavior seen in earlier precedent, is not intuitively culpable or in contravention of the spirit of the Exchange Act. It was this apparently growing intuition surrounding the spirit of the Exchange Act that cried out for a more explicit address of the very problem the O'Hagan Court resolved: whose duties are at issue? What relationships matter?

II. RULE 10b5-2, CIRCA 2007

The more recent action by the Commission to promulgate new Rules 10b5-1 and 10b5-2 was a direct reaction to the O'Hagan decision and its

81. See supra at 8.
82. See supra at 14-15.
83. SEC Release 33-7881.
demonstrates that:

(A) Before becoming aware of the information, the person had:
(1) Entered into a binding contract to purchase or sell the security,
(2) Instructed another person to purchase or sell the security for the instructing person's account, or
(3) Adopted a written plan for trading securities;
(B) The contract, instruction, or plan described in paragraph (c)(1)(i)(A):
(1) Specified the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold;
(2) Included a written formula or algorithm, or computer program, for determining the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; or
(3) Did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales; provided, in addition, that any other person who, pursuant to the contract, instruction, or plan, did exercise such influence must not have been aware of the material nonpublic information when doing so; and
(C) The purchase or sale that occurred was pursuant to the contract, instruction, or plan.
A purchase or sale is not "pursuant to a contract, instruction, or plan" if, among other things, the person who entered into the contract, instruction, or plan to purchase or sell securities (whether by changing the amount, price, or timing of the purchase or sale), or entered into or altered a corresponding or hedging transaction or position with respect to those securities.

(ii) Paragraph (c)(1)(i) of this Rule 10b5-1 is applicable only when the contract, instruction, or plan to purchase or sell securities was given or entered into in good faith and not as part of a plan or scheme to evade the prohibitions of this Rule 10b5-1.

(iii) This subparagraph defines certain terms as used in paragraph (c).
(A) Amount. "Amount" means either a specified number of shares of other securities or a specified dollar value of securities.
(B) Price. "Price" means the market price on a particular date or a limit price, or a particular dollar price.
(C) Date. "Date" means, in the case of a market order, the specific day of the year on which the order is to be executed (or as soon thereafter as is practicable under ordinary principles of best execution). "Date" means, in the case of a limit order, a day of the year on which the limit order is in force

(2) A person other than a natural person also may demonstrate that a purchase or sale of securities is not "on the basis of" material nonpublic information if the person demonstrates that.
(i) The individual making the investment decision on behalf of the person to purchase or sell the securities was not aware of the information; and
(ii) The person had implemented reasonable policies and procedures, taking into consideration the nature of the person's business, to ensure that individuals making investment decisions would not violate the laws prohibiting trading on the basis of material nonpublic information. These policies and procedures may include those that restrict any purchase, sale, and causing any purchase or sale of any security as to which the person has material nonpublic information, or those that prevent such individuals from becoming aware of such information.

Rule 10b5-2. Duties of Trust or confidence in Misappropriation Insider Trading Cases.

Preliminary Note to Rule 10b5-2: This Rule 10b5-2 provides a nonexclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the "misappropriation" theory of insider trading under Section 10(b) of the Exchange Act and Rule 10b-5. The law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5, and Rule 10b5-2 does not modify the scope of insider trading law in any other respect.

(a) Scope of Rule. This Rule 10b5-2 shall apply to any violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder that is based on the purchase or sale of securities
progeny and an attempt to better define the circumstances where the misappropriation theory applies. Many critics have seen these new rules as a blatant overstepping of bounds by the Commission. Others have opined that the new rules did not go far enough.

Rule 10b5-1 was constructed with regard to trading in securities to define “on the basis of” material nonpublic information. The definition hinges on whether the person making the purchase or sale was “aware” of the material nonpublic information at the time of the trade. Certain affirmative defenses are named in the rule. These defenses (subject to certain details) center on whether the trading was at the direction of a preexisting plan or contract.

Rule 10b5-2 seeks to define what are or where exist “duties of trust or confidence.” Such duties arise where a person “agrees to maintain information in confidence,” where there is a history or pattern of the sharing of such confidences between the parties or when a person receives the information from a spouse, parent, sibling or child, unless the absence of a trusting relationship is shown.


These rules were intended to work together with Rule 10b-5’s basic prohibition on (i) employing a device, scheme or artifice to defraud, (2) to make an untrue statement of a material fact or omission . . . (3) to carry out fraud or deceit on a person. In essence, they were an attempt to include outsiders, or at least peripheral quasi-insiders, within the scope of 10b-5, which, prior to O’Hagan’s adoption of the misappropriation theory, ultimate case law had never done. This codification was certainly intended to give the Commission authority well beyond the “Classical Theory” precedent and in direct contradiction to the limits that Bryan would have imposed.

Yet, few cases since the adoption of Rules 10b5-1 and 10b5-2 have indicated an explicit following among the federal courts of the would-be codification of O’Hagan. Cases under 10b-5 are necessarily fact based. While some cases turn on facts directly under 10b5-1—determining whether a person was “aware of” the nonpublic information or traded “on the basis” of the nonpublic information, my interest is in the relationships contemplated by Rule 10b5-2 and whether such relationships give rise to duties of trust or confidence.

Since adoption of the new rules, courts have found duties of trust and confidence in relationships between employer and employee and between former employer and former employee. This is really nothing new. Such relationships were found to be locuses of fraud well before O’Hagan. In Falcone, decided after O’Hagan and the new rules, but relying on O’Hagan and apparently not considering the rules, the Second Circuit found that a duty of trust and confidence existed between a printer and its news distributor/wholesaler.

Courts have also recently looked at relationships among members of an executive business club and between CEOs of an intended target and its planned acquiror and have failed to find duties of trust and confidence. In a current case particularly eschewing of the new rules, the Talbot court, like the Kim court before it, looked back to Chestman as the kingpin in the relationship analysis and relied upon language from Chestman that, “reliance and de facto control and dominance such that confidence is reposed on one side and there is resulting superiority and influence on another” defined the test of trust or confidence. Chestman was, of course, decided long before both O’Hagan and the promulgation of Rules 10b5-1 and 2. (However, that decision readily appears to have informed the

86. A rule written, perhaps, to address the problem of getting around scienter presented in Smith and Adler.
87. S.E.C. v. Cherif, 933 F.2d 403 (7th Cir. 1991).
89. United States v. Falcone, 257 F.3d 226 (2d Cir. 2001).
language and substance of Rule 10b5-2.)

Each of the cases referred to here demonstrates the importance of facts characterizing relationships between parties giving or receiving material nonpublic information and the courts' understanding of those relationships in light of the law. They tell us that even a contractual agreement treating information as confidential need not constitute adequate evidence of a relationship giving rise to duties of trust or confidence and that the existence of Rule 10b5-2 on top of relationship examining case law can be treated as utterly superfluous.

III. So What Has 10b5-2 Done?

That 10b5-2, or O'Hagan, for that matter, has truly settled any kind of bright line standard is most doubtful. Courts appear to favor their own handpicked precedent, and if they must give due attention to O'Hagan, show, at the same time, a lack of deference to the new (now seven-year-old) rules. Rule 10b5-2 has been blatantly overlooked.

O'Hagan appears to be here to stay. Consequently, some version of the misappropriation theory is here to stay. However, the version codified with Rules 10b5-1 and 10b5-2 is not certain to prevail for the long run. At best, these rules have contributed to the categorization of relationships subject to securities fraud litigation that had begun long before O'Hagan. While the regulations define characteristics of those relationships and actually name several, they do not provide an exhaustive list, nor do they offer true certainty. Each case under O'Hagan and the new rules will continue to be fact determinative as the history of a family relationship or the actual reliance in a business relationship must be analyzed beyond its prima facie description.

So the Talbot court was not radical in its controlling look back to Chestman, as the Kim court and Falcone court before it. It was, ironically, performing the same sort of analysis called for under Rule 10b5-2, even if not under its rubric. Both the Talbot analysis disregarding the new rule and an analysis under 10b5-2 require a close consideration of the dispositive relationship really as a result of O'Hagan or at least more as a result of O'Hagan, as it is only since O'Hagan that the Supreme Court has made it perfectly clear that duties subject to 10b-5 exist between or among outsiders – those with no direct connection to the issuer of the stock traded on material information. It is O'Hagan's explicit adoption of fraud on the source misappropriation that has forever broadened the scope of relationships to be examined, but the manner in which those relationships are to be scrutinized is more a furtherance of preexisting case law. Under Kim and Talbot, it appears that Rule 10b5-2 may be entirely superfluous.
Enough case law may exist defining a relationship of trust or confidence without it. There is no indication, however, that 10b5-2 is contradictory of prior securities fraud decisions.

As to our overarching concern with the Commission's policy motivations, it appears that the Commission has apparently not chosen to direct, or has not been able to direct, litigation toward the boundary pushing edge of the market either since O'Hagan or since the new rules.\footnote{92} O'Hagan and the cases under the new rules focus on professional, family or employment relationships. These relationships are old school.

We have no indication that the investors most capable of effecting market volatility are being looked after by the Commission as a result of O'Hagan or the new rules in any way more seriously than before O'Hagan or the new rules. Indeed, the express exemption of planned trading under Rule 10b5-1 would appear to create a kind of safe harbor for hedging programs. Moreover, Rule 10b5-2's lack of any certain enumerated written contractual relationship seems to overlook those either expressly representing, or at least fully informed of, deals in the making as a definite source of duties of trust or confidence.

Thus, rather than creating at least an impression of greater scrutiny at the edge of an arguably information-based bifurcated market where volatility is heightened, the Commission's rulemaking and subsequent litigation indicates concern with the same traditional relationships addressed in securities litigation for decades.

In sum, though several recent decisions have addressed the relationship issue under O'Hagan, including those which Rule 10b5-2 was drafted to control, the post-O'Hagan landscape on relationships giving rise to duties of trust or confidence is, as yet, unchanged. We can only conclude that the Commission is not actively targeting any particular market segment or practice, but is seeking to promote fair and efficient markets generally.

\footnote{92. Of course, we are looking at case law, not all attempted or settled enforcement actions. For some discussion of recent related enforcement actions see Hiler, Kuczajda, & Helm, \textit{supra} note 3.}