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Section 10(b) and the Fiduciary Conundrum

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TABLE OF CONTENTS

I. INTRODUCTION

U.S. law on securities fraud, particularly insider trading, is a common law creation constructed with federal courts' interpretations and applications of Rule 10b-5.[1] Since *O'Hagan*,[2] so is outsider trading.[3] Rule 10b-5 was

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1. 17 C.F.R. § 240.10b-5 (2011) ("It shall be unlawful for any person, directly or indirectly, . . . [t]o employ any device, scheme, or artifice to defraud, . . . or . . . [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.").

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

3. *See generally*, Thomas M. Madden, *O'Hagan, 10b5-2, Relationships and Duties*, 4 HASTINGS BUS. L.J. 55 (2008). By "outsider trading", I mean actions found in violation of SEC rules promulgated under Section 10(b) which actions are not premised on a fiduciary relationship owed by the securities trading party to the issuer of those securities nor to that issuer's stockholders. Outsider trading is premised

promulgated by the Securities and Exchange Commission (SEC or Commission) under Section 10(b) of the Securities Exchange Act of 1934[4] (Section 10(b)) is the Commission's primary anti-fraud provision governing securities transactions. Since the 1968 *Texas Gulf Sulfer*[5] decision, the Second Circuit, perhaps as much as the U.S. Supreme Court, has articulated and adopted theories of insider and outsider trading. No such theory has been more contentious than the misappropriation theory as codified by the

on the fraud on the source version of the misappropriation theory adopted in Justice Ginsburg's majority opinion in *O'Hagan*.

4. 15 U.S.C. § 78j(b) (2010). It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

5. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (establishing the disclose or abstain rule).

Commission in Rules 10b5-1[6] and 10b5-2[7] subsequent to the Supreme Court's adoption of fraud-on-the-source misappropriation in the 1997 *O'Hagan* decision.[8]

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6. Rule 10b5-1, 17 C.F.R. § 240.10b5-1 (2021). Trading "On the Basis Of" Material Nonpublic Information in Insider Trading Cases.

Preliminary Note to Rule 10b5-1: This provision defines when a purchase or sale constitutes trading "on the basis of" material nonpublic information in insider trading cases brought under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5, and Rule 10b5-1 does not modify the scope of insider trading law in any other respect.

(a) General. The "manipulative and deceptive devices" prohibited by Section 10(b) of the Exchange Act and Rule 10b-5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.

(b) Definition of "On the Basis Of." Subject to the affirmative defenses in paragraph (c) of this Rule 10b5-1, a purchase or sale of a security of an issuer is "on the basis of" material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale.

(c) Affirmative Defenses.

(1) (i) Subject to paragraph (c)(1)(ii) of this Rule 10b5-1, a person's purchase or sale is not "on the basis of" material nonpublic information if the person making the purchase or sale 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

Since *O'Hagan*, the misappropriation theory and its codification in 2000 in Rules 10b5-1 and 10b5-2 has remained underutilized, if not controversial. Why? The core of critiques and discussions on the topic ultimately center on the concept of fiduciary duty.[9] The federal courts have failed to adequately elucidate the proper role of fiduciary duty in the federal common law of insider, and now outsider, trading nearly twenty years after the Commission's promulgation of Rules 10b5-1 and 10b5-2; rules intended to settle broadly recognized incongruity surrounding the role.[10]

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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.

7. Rule 10b5-2, 17 C.F.R. § 240.10b5-2 (2021). 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 on the basis of, or the communication of, material nonpublic information misappropriated in breach of a duty of trust or confidence.

(b) Enumerated "Duties of Trust or Confidence." For purposes of this Rule 10b5-2, a "duty of trust or confidence" exists in the following circumstances, among others:

(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; provided, however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential, because of the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information.

8. *See generally,* Thomas M. Madden, *O'Hagan, 10b5-2, Relationships and Duties*, 4 HASTINGS BUS. L.J. 55 (2008).

9. *See generally*, Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trad*ing, TEX. L. REV. (1999) and Donna Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315 (2009).

10. *See, e.g.,* SEC v. Cuban, 634 F. Supp. 2d 713, 729-31 (N.D. Tex. 2009), *vacated and remanded*, 620 F.3d 551 (5th Cir. 2010). *See* Robert A. Prentice, *Permanently Reviving the Temporary Insider,* 36

The conundrum this article addresses is the still unclear, still shifting federal courts' understanding of the meaning and role of fiduciary duty under Section 10(b), and how it relates and whether it is synonymous with the "duty of trust or confidence" addressed in Rules 10b5-1 and 10b5-2 and the federal case law interpreting those rules.[11] It builds on earlier work seeking to examine what use the Commission has made of Rule 10b5-2.[12]

Part II of this work frames the current milieu of federal court decisions addressing the fiduciary duty conundrum and its associated applications or disregard of Rules 10b5-1 and 10b5-2 (with necessary reference to earlier precedent under Rule 10b-5). Part III, fleshes out the concept of fiduciary duty under Section 10(b), noting its role at the heart of common law securities fraud. Part IV, proposes that modifying and better employing Rule 10b5-2 would help to clarify the fiduciary conundrum under Section 10(b) and would be instrumental in doing away with the common law's misnomers and confusion.

II. SECURITIES FRAUD, FEDERAL COURTS, AND FIDUCIARY DUTY

Prior to *O'Hagan* and Rules 10b5-1 and 10b5-2, common law explication of insider trading under Section 10(b), at least since *Dirks*,[13] if not *Chiarella*,[14] was generally explicitly premised on the breach of a fiduciary duty. This is distinguishable from the Commission's earlier abstain or disclose approach to securities fraud set out in *Cady Roberts*[15], also known as the parity-of-information approach.[16]

IOWA J. CORP. L. 343 (2011) (addressing, inter alia, the role of Rule 10b5-2 in SEC v. Cuban). *See also,* John C. Coffee, Jr., *Symposium: The Past, Present, and Future of Insider Trading Law: A 50th Anniversary Re-Examination of Cady, Roberts and the Revolution It Began; Mapping the Future of Insider Trading Law: Of Boundaries, Gaps and Strategies*, 2013 COLUM. BUS. L. REV. 281 (2013) (addressing the common law of insider trading through the element of deception and proposing Rules 10b5-3 and 10b5-4).

11. Selective Disclosure and Insider Trading, Exchange Act Release No. 7881 (Aug. 15, 2000); 17 C.F.R. 240, 243, 249 (2011); 17 C.F.R. 240.10b5-1 and 10b5-2 (2011). *See generally* Madden, supra note 2, at 72-75 (assessing the lack of use or recognition of Rule 10b5-2 in the federal courts).

12. *Id.*

13. Dirks v. SEC, 463 U.S. 646, 653-54 (1983) (holding that an officer of a broker-dealer who learned of fraudulent accounting in a corporation and informed clients who traded on the basis of that information in securities of the fraud committing corporation owed no fiduciary duty to shareholders of the fraud committing corporation in whose stock the clients traded).

14. Chiarella v. United States, 445 U.S. 222, 227-30 (1980) (holding that a financial printer employee who learned of forthcoming securities transactions owed no fiduciary duty or similar duty of trust and confidence to his employer printer clients and had no duty to disclose the information he learned of from the printer's clients, which information motivated his securities trades in issuers involved in the forthcoming transactions).

15. *In re* Cady, Roberts & Co., Exchange Act Release No. 6668, 40 SEC Docket 907 (Nov. 8, 1961).

16. *See* Donald C. Langevoort, *Fine Distinctions in the Contemporary Law of Insider Trading*, 2013 COLUM. BUS. L. REV. 429, 432 (2013) (discussing the transition from SEC Chairman Carey's influence on defining insider trading to Justice Powell's influence via *Chiarella* and *Dirks*) and *see generally*

In both *Chiarella* and *Dirks*, Justice Powell was explicit and repetitive in using the words "fiduciary duty," setting out what became known as the "classical theory" of insider trading, itself a misnomer in place of securities fraud.[17] Justice Powell built upon his previous discussion of relationships giving rise to duties of trust and confidence in *Chiarella* and constructed in *Dirks* his general fiduciary breach framework, which he apparently envisioned would control future anti-fraud actions brought under Rule 10b-5.[18] In so doing, Powell had perhaps the greatest personal impact on establishing federal law on insider trading.

A.C. Pritchard has documented Justice Powell's conscious, careful construction of a federal fiduciary principle that both contained the expansion of Section 10(b) and, for the time being, warded off the Court's adoption of the misappropriation theory.[19] It is clear that Powell did this expressly to avoid a chilling effect on securities analyst information digging, assessment, and reward – pointedly rejecting the earlier parity-of-information approach to insider trading and focusing instead on relationship characteristics that would give rise to a duty.[20] Powell sought to construct a justifying principle that could control future insider trading cases while not dissuading market research and earned advantage.[21] Yet, the adopted principle, a federal fiduciary duty, has proven both vexing and difficult to apply consistently to subsequent trading scenarios. Indeed, several scholars have concluded that the very notion of emphasizing fiduciary duty in the common law of insider trading was a contrivance.[22]

A. POWELL'S CLASSICAL THEORY FIDUCIARY DUTY

Fiduciary duty is generally defined as a "duty to act for someone else's benefit, while subordinating one's personal interests to that of the other

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Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Review*, 70 CALIF. L. REV. 1 (1982).

17. *See* Nagy, *supra* note 9, at 1326 ("Justice Powell invoked the term "fiduciary" a total of seven times in Chiarella's majority opinion.").

18. *See* A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L.J. 841, 933 (2003).

19. *Id.*

20. *Dirks*, 463 U.S. at 658 ("Imposing 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 SEC itself recognizes is necessary to the preservation of a healthy market."); *see also*, Pritchard, *supra* note 18, at 937-941.

21. Pritchard, *supra* note 18, at 937-41.

22. *See* Nagy, *supra* note 9, at 1337-40 (discussing "fiduciary fictions" and noting that insider trading actually turns on the "wrongful use of confidential information"). *See also* Coffee, *supra* note 10, at 289-90 (discussing Dirks as a product of its time . . .), Prentice, *supra* note 10, at 345 ("Obviously, insider trading law is a work in progress. Because Congress and the SEC have declined to promulgate a specific, thorough definition of insider trading, it has been left to the courts to define it on the fly. Insider trading law should be fleshed out in accordance with a reasonable understanding of relevant policy considerations."); *and* Langevoort, *supra* note 16, at 440 (writing of insider trading that "[i]t is not really fraud, even though we have chosen to call it fraud in order to preserve and embellish the useful message of investor protection.").

person. It is the highest standard of duty implied by law (e.g., trustee, guardian)."[23] It may be that Powell misused the fiduciary duty concept in the securities anti-fraud context – largely as a result of the need to fill a void in the common law construction of insider trading. While Powell and the classical theory depend upon the breach of a known duty described as fiduciary duty, that duty may not actually refer to a true fiduciary standard. More accurately, as subsequent courts have opined, it may refer to a "fiduciary-like" relationship.[24] Herein lies the conundrum.

In the context of tipping as in *Dirks*, Justice Powell's version of the breach of fiduciary duty under Section 10(b) has two parts. First, a relationship giving rise to a duty must exist.[25] (This duty is owed to the shareholders of a corporation whose stock is to be traded and the duty may be inherited by a tippee.)[26] Second, the trader (often tippee) must know or should know of both the duty and its breach (the tippee inheriting or deriving the duty of the tipper).[27] That knowledge, or would-be knowledge, (i) must include the existence of a personal benefit to the tipper in tipping the tippee and (ii) that personal benefit must be either (a) of a pecuniary nature or (b) in the nature of the benefit of gift giving.[28] In the *Dirks* Court's words, ". . . a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."[29] After finding the duty, the determination turns on "whether the insider receives a direct or indirect *personal benefit* from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings"[30]

> ". . . [T]here may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient. The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient."[31]

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23. *Fiduciary Duty*, BLACK'S LAW DICTIONARY 625 (6th ed. 1990).

24. *See*, *e.g.*, United States v. Chestman, 947 F.2d 551, 567 (2d Cir. 1991) (employing the term to refer to the relationship at issue under Rule 10b-5).

25. *Dirks*, 463 U.S. at 660-61.

26. *Id.*

27. *Id.* at 663.

28. *Id.; See* Langevoort, *supra* note 16 at 447-448. *See also*, Donna M. Nagy, *Beyond Dirks: Gratuitous Tipping and Insider Trading*, 42 J. CORP. L. 1, 3-4 (2016).

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

30. *Id.* at 663 (emphasis added).

31. *Dirks*, 463 U.S. at 664.

This less than crystal clear writing has left subsequent courts to sort out what fiduciary duty really means in the securities fraud context, and whether the "personal benefit test" applied to determine the purpose of inside information disclosure and resultant breach of that duty requires that a tipper will at least share in profits via a tippee's trade.[32] Though the underlying breach of fiduciary duty is named, the Court's surrounding verbiage is cloudy and in no way explicit. The Court's language ranges from "elements" or qualities, to duties "like" fiduciary duties.

Powell's actual discussion concerning the definition and nature of fiduciary duty was quite limited in *Dirks*.[33] His focus was rather on the purpose of disclosure in determining breach of the duty and, ultimately, deception.[34] In looking to *Chiarella* and *Cady Roberts*, Powell summarily adopted the fiduciary requirement without expounding on it.[35] Tellingly, however, he quoted language from *Chiarella* holding that a breach of fiduciary duty cannot exist where the party trading on the inside information "was not a fiduciary, [or] *was not a person in whom the sellers [of the securities] had placed their trust and confidence*."[36] In fact, Powell's version of fiduciary duty may, in practice, be more akin to Rule 10b5-2's codification of duties of trust or confidence – which clearly established a lower threshold than a true fiduciary relationship of one bound to act in the best interest of another.[37] Yet, at the very least, Powell's version does require the finding of a relationship of trust and confidence. The conundrum leads us to wonder, why all the fuss on the fiduciary terminology when the actual focus appears to be on a duty of trust or confidence that can exist outside of strict fiduciary relationships obligating one party to act in the best interest of another.

1. Subsequent Decisions Looking to Powell's Fiduciary Duty

Since *Dirks*, the cloudiness surrounding Powell's fiduciary duty appears to be, at least in part, due to the U.S. Supreme Court's failure to clearly elucidate what defines fiduciary duty in the securities fraud context, or what characteristics of such a duty matter in finding deception or fraud under Section 10(b). The problem is that subsequent decisions by federal circuit and federal district courts have almost continually looked back to *Dirks* to resolve the issue. Of course, this looking back is necessary due to our common law system of precedent. In this instance, the precedent is problematic because *Dirks* simply did not give us functional clarity. Moreover, the federal courts' almost inescapable lack of accuracy and consistency in embracing and applying the fiduciary duty concept that has

32. *See generally* Donald C. Langevoort, *Informational Cronyism*, 69 STAN. L. REV. ONLINE 37, 40-43 (2016).

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

34. *Id.* at 662.

35. *Id.* at 654.

36. *Id.* (citing *Chiarella*, 445 U.S. at 232.) (emphasis added).

37. *See infra* Part II.C.

resulted since *Dirks*, has only grown more puzzling as judge after judge has genuinely attempted to make sense of the fiduciary conundrum.[38]

Again, a fiduciary relationship is characterized by a one-way obligation born by the fiduciary to act in the best interest of another. This is the sort of overt, proactive duty that is not simply one of either unidirectional or reciprocal trust and confidence. Yet, in reality, it certainly and logically appears that Powell's real concern with fiduciary duty was in fact with a relationship of trust and confidence, not a one-way duty of an agent to act in the best interest of a principal or beneficiary.

The federal court that confronted this reality most directly was the Northern District of California in *United States v. Joon Kim.*[39] In *Kim*, the Northern District of California looked to the Second Circuit's 1991 *Chestman*[40] decision that informed, and in large part motivated, the Commission's adoption of Rule 10b5-2. *Kim* attended to the *Chestman* court's discussion of a similar relationship of trust and confidence in addition to a fiduciary relationship *per se*.[41] This expansion was not, however, intended in a broad sense. Rather, the similar relationship of trust and confidence was explicitly considered in the sense of a "functional equivalent" to fiduciary duty.[42] *Kim* expounded and reiterated that the relationship at issue was defined by one side being superior to the other, and repeated the need to find "superiority, dominance and control."[43] Thus, the *Kim* court refused to find the existence of such a duty among members of a CEO club, though those members regularly shared confidential information, because those members shared as equals.[44] The *Kim* court focused on true fiduciary duty – most likely interpreting the conundrum more strictly than intended.

Chestman, discussing both classical and misappropriation theories, offered perhaps the most robust discussion of both fiduciary duty and the companion relationship of trust and confidence.[45] On the fiduciary relationship, *Chestman* looked fairly deeply at the nature of a fiduciary and included the observation that a fiduciary exercises "discretionary authority" for a dependent beneficiary.[46] Moreover, the *Chestman* court noted that the relationship entailed the obligation of agent confidentiality.[47] Emphasizing a narrow scope, *Chestman* then looked to *Reed*[48] to recognize that a

38. *See infra* Parts II.B and II.C.

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

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

41. United States v. Joon Kim, 184 F. Supp. 2d 1006, 1010 (N.D. Cal. 2010) (citing *Chestman*, 947 F.2d at 566).

42. *Id.* at 1010 (citing *Chestman*, 947 F.2d at 568).

43. *Id.* at 1010-1011.

44. *Id.* at 1018.

45. *Chestman*, 947 F.2d at 567-70.

46. *Id.* at 569.

47. *Id.*

48. United States v. Reed, 601 F. Supp. 685, 690 (S.D.N.Y.), rev'd on other grounds, 773 F.2d 477 (2d Cir. 1985).

relationship characterized by repeated sharing of confidential information, even without the clear duty of an agent to act in the best interest of a dependent beneficiary, took on the nature of a fiduciary relationship.[49] This "less rigorous" version of fiduciary duty, though not generally accepted by the *Chestman* court in a criminal fraud context, allows a broader reach, and though lacking precision, appears closer to Powell's construction in *Dirks*.[50] *Chestman* interprets the conundrum closer to Powell's apparent intentions in *Dirks* and *Chiarella*.

Powell's understanding of a fiduciary relationship in *Dirks* is first and foremost the traditional configuration – one owed by an insider to a corporation's shareholders, and upon knowing breach, inherited by a tippee from the insider tipper.[51] Yet, Powell offered little or no discussion of a superior-inferior relationship. He focused rather on a notion of largely reciprocal confidentiality between tipper and tippee, not on a one-way duty to act in the best interest of another.[52] Even recognizing the underlying relationship between a corporate insider and that corporation's shareholders, Powell's notion is markedly distinct from a true, one directional fiduciary relationship. Not surprisingly, this distinction has been conflated and confused in the courts since *Dirks*.[53] Courts appear to have continued to strive for accurate interpretation of the unclear rule in *Dirks* rather than to have seized the opportunity to clarify the nature of the duty to be found under Section 10(b), though Rule 10b5-2 may have handed courts just that opportunity twenty years ago.

2. The Recent Focus on Personal Benefit

In finding no fiduciary duty owed to a subject corporation's shareholders by analysts learning of fraudulent accounting practices in that publicly traded corporation, *Dirks* shifted focus from defining an underlying would-be fiduciary duty to the nature of disclosure constituting breach of the duty.[54] This judgment of purpose required determining whether tippers received a personal benefit in disclosing the fraud to tippees who then traded in the corporation's stock.[55] Such consideration became vital because

49. *Chestman*, 947 F.2d at 569-70 (citing United States v. Reed, 601 F. Supp. 685, 690 (S.D.N.Y.), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985).

50. *Id.*

51. Dirks v. SEC, 463 U.S. 646, 660 (1983).

52. *Id.* at 655 ("The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.").

53. *See*, *e.g.*, United States v. Newman, 773 F.2d. 438, 445-46 (2d Cir. 2014) (when analysis proceeds via the misappropriation theory rather than the classical theory, the personal benefit test has a more defining role in establishing the breach of a fiduciary or fiduciary-like duty because it may involve deciding whether the relationship at issue in the fraud on the source determination is or is not meaningful); United States v. Salman, 792 F.3d 1087, 1093 (9th Cir. 2015).

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

55. *Id.* at 666-667.

"[w]hether disclosure is a breach of duty . . . depends in large part on the purpose of the disclosure."[56] Confidential information shared for a proper purpose would not constitute a breach, but such information shared for a personal benefit would. At first read, the decision appears to turn here, "[i]n the absence of a breach of duty to shareholders by the insiders, there was no derivative breach by Dirks."[57] Yet, the Court seems, at the same time, to hinge its decision on the finding that the "tippers received no monetary or personal benefit for revealing Equity Funding's secrets, nor was their purpose to make a gift of valuable information to Dirks."[58]

If there is a real difference in distinguishing Powell's analysis of the breach of fiduciary duty from other understandings of breach and fiduciary duty generally, it lies in part in the concept of Powell's personal benefit test set out in *Dirks*.[59] It may be that the personal benefit test has become the latest incarnation of the fiduciary conundrum – another manifestation of a duty of trust and confidence cloaked in a duty to act in another's best interest.

The would-be clarification of the personal benefit test came in 2016 with the U.S. Supreme Court's *Salman*[60] decision. The Court granted cert. in *Salman* to resolve an apparent disparity between the Second Circuit's *Newman*[61] decision and the Ninth Circuit's *Salman* decision.[62] Previously, the *Newman* court had held that a personal benefit was essential in finding Section 10(b) liability.[63] *Newman* looked to *Dirks* to find the requirement of (i) a fiduciary breach by an insider, (ii) the inheritance of that breach by a trading tippee, and (iii) the trading tippee's knowledge that the information resulted from that breach.[64] From there, *Newman* noted that a personal benefit to the breaching insider must be found.[65] Then, *Newman* held that to actually find Rule 10b-5 liability, the tippee trader must know of that personal benefit to the insider/tipper.[66] This explication by Judge Barrington Parker, propounded in reviewing the Southern District's jury instructions below, resulted in overturning the Southern District's prior conviction in the case.[67]

Moreover, as Judge Parker delved further into *Newman*, fleshing out the personal benefit analysis derived from *Dirks*, he explained that the concept of knowing of the personal benefit could be found either (i) where benefit to the tipper was pecuniary or (ii) where the tip entailing a tipper's gift of the

56. *Id.* at 662.
57. *Id*. at 667.
58. *Id.*
59. *Id.*
60. Salman v. United States, 137 S. Ct. 420, 425 (2016).
61. United States v. Newman, 773 F.3d 438 (2d Cir. 2014).
62. *Salman*, 792 F.3d at 1092.
63. *Newman*, 773 F.3d at 447.
64. *Id.*
65. *Id.*
66. *Id*. at 448.
67. *Id.*

information to be traded upon would enhance the tipper's reputation, which enhancement could only be inferred where a "meaningfully close personal relationship" exists between tipper and tippee.[68] Here, Judge Parker wrote that a "mere friendship" would not meet this latter standard.[69] Ultimately, of course, *Newman* turned on two conclusions. [70] First, the *Newman* court concluded that no inference could be drawn from the facts of the case as to a relationship of the analysts covering the Dell-NVDIA transaction at issue with the alleged tippees in finding any such personal benefit.[71] Second, the court found that no meaningful personal relationship existed among the alleged investor relations insider tipper, industry analyst tippees, and disseminators.[72]

In *Salman*, the U.S. Supreme Court apparently rebuked the Second Circuit's application of the personal benefit test in *Newman*.[73] Writing for the majority in *Salman*, Justice Alito made clear that *Dirks* would again control the general securities fraud analysis, and that the issue in the instant case would again center on the existence of a personal benefit to an insider tipper who informed a trading tippee.[74] Justice Alito saw the turning point in the decision as simple. "Dirks makes clear that a tipper breaches a fiduciary duty by making a gift of confidential information to "a trading relative," and that rule is sufficient to resolve the case at hand."[75] The tippee trader, Salman, was a brother-in-law of a tipping insider and close friend of an intermediary.[76] Justice Alito repeatedly relied on language from *Dirks*, "[i]n particular, we held [in *Dirks*] that "[t]he elements of *fiduciary duty* and exploitation of nonpublic information also *exist when an insider makes a gift of confidential information to a trading relative or friend*." *Ibid*."[77]

So the relationship of the tipper and tippee characterized as that of a close relative or friend was enough to infer the personal benefit and rely on *Dirks* to find liability in *Salman* while the Second Circuit had not found such an inference in *Newman*, albeit under clearly distinguished facts. In affirming Judge Rakoff's Ninth Circuit *Salman* decision, Justice Alito took pains to qualify Judge Parker's approach in *Newman*.He wrote,, "[t]o the extent the Second Circuit held that the tipper must also receive something of a 'pecuniary or similarly valuable nature' in exchange for a gift to family or friends, *Newman*, 773 F. 3d, at 452, we agree with the Ninth Circuit that ***this requirement is inconsistent with Dirks***."[78] This is to say that what really

68. *Id.* at 452.
69. *Id.*
70. *Id.* at 453.
71. *Id.*
72. *Id.*
73. *Salman*, 137 S. Ct. at 423.
74. *Id.*
75. *Id.* at 427.
76. *Id.* at 424.
77. *Id.* at 427.
78. *Id.* at 428. (emphasis added).

matters in Alito's interpretation in *Salman* is consistent with the real meaning behind the fiduciary conundrum in Powell's *Dirks* and *Chiarella*. That real meaning iswhether a relationship of trust and confidence exists, and whether it has been breached. Clearly, a family relationship (as in *Salman*) is declared to constitute a presumed relationship of trust and confidence, the breach of which would constitute a violation of Rule 10b-5. This is so notwithstanding the focus on the more narrowly framed issue of personal benefit in place of a would-be general fiduciary duty.

After the Supreme Court spoke on the issue in *Salman*, the Second Circuit revisited the same personal benefit issue in its 2017 *Martoma II* decision,[79] In *Martoma II*, Judge Katzmann turned again to the personal benefit test, looking to the U.S. Supreme Court's *Salman* decision, and refused to recognize whether Alito's opinion had actually rebuked Judge Parker's preceding *Newman* decision in its interpretation of the personal benefit test.[80] *Martoma II* affirmed a lower court conviction notwithstanding what it found to be inaccurate jury instructions regarding the personal benefit test.[81] Pointedly, Katzmann's majority opinion in *Martoma II* noted that the personal benefit test could be read in either of two ways – with the meaningful personal relationship between tipper and tippee necessarily included together with a tipper's intent to benefit from providing the non-public information to a tippee, or alternatively, either element found independent of the other.[82] The Katzmann majority chose the latter reading (relying on the Second Circuit's *SEC v. Warde*[83]), and then reasoned that the facts at trial were sufficient to meet that standard, justifying its affirmance of the lower court conviction, notwithstanding the jury instruction nuances.[84] Thus, a doctor's disclosure of the not yet public Elan-Wyeth Phase 2 Alzheimer drug trial results to an investor hedge fund manager was enough to demonstrate an adequate personal benefit either on the facts that the disclosing doctor received a quid-pro-quo-like consulting fee *or* on the facts that the disclosing doctor received a personal benefit with the intention of that the tippee benefit from the disclosure.[85]

Since Powell and his construction of the would-be controlling fiduciary principle, the most influential judge opining on insider and outsider trading may be Jed S. Rakoff, albeit not as a justice of the U.S. Supreme Court, but as a judge on the Southern District of New York, and as a designated judge

79. United State v. Martoma, 894 F.3d 64 *passim* (2d Cir. 2017), *cert. denied*, 139 S. Ct. 2665 (2019) [hereinafter *Martoma II*].

80. *Id.* at 71.

81. *Id.* at 68.

82. *Martoma II*, 894 F.3d at 74.

83. SEC v. Warde, 151 F.3d 42, 48 (2d Cir. 1998).

84. *Martoma II*, 894 F.3d at 74. *See* Thai H. Park, *Newman/Martoma: The Insider Trading Law's Impasse and the Promise of Congressional Action*, 25 FORDHAM J. CORP. & FIN. L. 1, 49-52 (2019) (discussing the personal benefit test in *Martoma II* and beyond).

85. *Id.* at 74-75.

on both the Second and Ninth Circuits.[86] In both the Ninth Circuit's *Salman* [87] and in the Second Circuit's *Pinto-Thomaz*,[88] Judge Rakoff delved into the explication of fiduciary duty. Justice Alito affirmed Rakoff in the Supreme Court's *Salman* decision and led the Court to reiterate Rakoff's take on fiduciary duty from the Ninth Circuit, pointedly with no attention to Rules 10b5-1 and 10b5-2.[89]

In affirming Judge Rakoff's Ninth Circuit *Salman* decision, the Supreme Court accepted Powell's "principle" of fiduciary breach as controlling the finding of violations under Section 10(b).[90] Alito wrote in his Supreme Court *Salman* decision affirming Rakoff:

> In Dirks v. SEC, 463 U. S. 646, this Court explained that a tippee's liability for trading on inside information hinges on whether the tipper breached a fiduciary duty by disclosing the information. A tipper breaches such a fiduciary duty, we held, when the tipper discloses the inside information for a personal benefit. And, we went on to say, a jury can infer a personal benefit—and thus a breach of the tipper's duty—where the tipper receives something of value in exchange for the tip or "makes a gift of confidential information to a trading relative or friend." *Id*., at 664, 103 S. Ct. 3255, 77 L. Ed. 2d 911.[91]

Thus, the focus is on a breach of the Powell fiduciary principle enunciated in *Dirks*, which hinges on the existence of a personal benefit to the tipper and the tippee's knowledge of the personal benefit. Yet, the underlying issue of interpretation of the fiduciary conundrum is consistent. What really is at issue remains whether a duty of trust and confidence exists, and whether it is breached.

In both the Ninth Circuit and the U.S. Supreme Court *Salman* decisions, the authors are concerned to limit the permissiveness of information disclosure under the Second Circuit's *Newman*[92] decision, which permissiveness was heralded by a number of scholars.[93] *Newman* held that we cannot infer a tippee's knowledge of a personal benefit to his tipper when the relationship between tipper and tippee lacks "proof of a meaningfully close personal relationship that generates an exchange that is objective,

86. *See* United States v. Salman, 792 F.3d 1087 (9th Cir. 2015), aff'd, 137 S. Ct. 420 (2016) and United States v. Pinto-Thomaz, 352 F. Supp. 3d 287 (S.D.N.Y. 2018).

87. *See Salman*, 792 F.3d at 1092.

88. *See Pinto-Thomaz*, 352 F. Supp. 3d at 295.

89. *See* Salman v. United States, 132 S. Ct. 420, 429 (2016).

90. *Id.* at 425.

91. *Id.* at 423.

92. United States v. Newman, 773 F.3d 438 (2d Cir. 2014), *cert. denied*, 577 U.S. 874 (2015).

93. *See* Brief of Amicus Curiae Law Professors, Stephen Bainbridge, M. Todd Henderson, and Jonathan Macey in Opposition to the United States of America's Petition for Rehearing or Rehearing En Banc at 1, United States v. Newman 773 F.3d 438 (2014), (No. 13-1837-cr(L)), 2015 WL 1064409; *see also*, A.C. Pritchard, *Dirks and the Genesis of Personal Benefit*, 68 SMU L. REV. 857, 861 (2015); Pritchard, *supra* note 18; A.C. Pritchard, *Tributes to Professor Alan R. Bromberg: Dirks and the Genesis of Personal Benefit*, 68 SMU L. REV. 857 (2015).

consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."[94] Of course, the *Newman* Court again looked back to Powell's *Dirks* decision.[95]

In declining to follow a limited read of *Newman*, Rakoff wrote in the Ninth Circuit's *Salman*, that doing so…

> "would require us to depart from the clear holding of *Dirks* that the element of breach of fiduciary duty is met where an "insider makes a gift of confidential information to a trading relative or friend." *Dirks*, 463 U.S. at 664. Indeed, *Newman* itself recognized that the "'personal benefit is broadly defined to include not only pecuniary gain, but also, inter alia, . . . the benefit one would obtain from simply making a gift of confidential information to a trading relative or friend.'" *Newman*, 773 F.3d at 452 (alteration omitted) (quoting *United States v. Jiau*, 734 F.3d 147, 153 (2d Cir. 2013))."[96]

In all of this parsing out of the breach of a would-be fiduciary duty, the relationships that give rise to a duty, and the associated knowledge of a personal benefit inferred to be pecuniary if only relational, we find no attention given to Rule 10b5-2. One wonders why is there no discussion of Rule 10b5-2(b)'s standards of duties of trust or confidence particularly in the tipper-tippee scenarios where the misappropriation theory is most likely to be applied? Wasn't this rule intended to address just this issue? Any of these cases could have proceeded under the misappropriation theory as promulgated in Rules 10b5-1 and 10b5-2. If they had, the relationships at issue would have been redirected from control by the insufficiently clear *Dirks*, to control by defined relationships of trust or confidence, either as enumerated or principled under Rule 10b5-2.

B. MISAPPROPRIATION ADOPTION AND PROMULGATION

If Powell defined the federal law of insider trading, the "classical" theory, under Section 10(b) with his 1980 *Chiarella* and 1983 *Dirks* decisions, major change came in 1997 with Justice Ginsburg's adoption of the fraud-on-the-source misappropriation theory in *O'Hagan*[9798] With *O'Hagan*, the U.S. Supreme Court recognized that the relationship giving rise to a duty to disclose or abstain from trading need not be limited to insiders owing such a duty to issuing corporation shareholders in whose stock disputed trades were made.[99] Rather, a fraud on the source of the information, whatever that non-public source may be, could be enough to

94. *Newman*, 773 F.3d at 452.
95. *Id.*
96. *Salman*, 792 F.3d at 1094-95.
97. United States v. Salman, 792 F.3d 1087, 1093 (2015).
98. *See* Madden, *supra* note 2 at 58.
99. O'Hagan, 521 U.S. at 660.

establish the breach of a fiduciary-like duty or a relationship of trust or confidence leading to Section 10(b) securities fraud liability.[100]

Somewhat surprisingly, the federal courts' interpretation and application of the role of a fiduciary relationship in finding insider or outsider trading has remained unclear, or at least subject to debate, not only since *Dirks*, but even since the Commission's subsequent promulgation of the misappropriation theory in Rules 10b5-1 and 10b5-2, together with Reg. FD back in 2000.[101] Rule 10b5-1 "defines when a purchase or sale constitutes trading "on the basis of" material nonpublic information in insider trading cases brought under Section 10(b)."[102] Under Rule 10b5-1, the "on the basis of" element is met where the trader has awareness of the material nonpublic information.[103] Moreover, Rule 10b5-1(a) expressly applies to those trades that are made with an awareness of that material nonpublic information "in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, *or to any other person who is the source of the material nonpublic information*."[104] This rule obviously is both informed by, and contemplates, varied tipper-tippee scenarios at issue in prior Rule 10b-5 cases.

Thus, Rule 10b5-1 incorporates the fraud on the source version of the misappropriation theory from Ginsburg's majority opinion in *O'Hagan.*[105] At the same time, the rule fails to include the word "fiduciary" even while speaking to the all-important "duty of trust *or* confidence."[106]

Even under the misappropriation theory, in all of this parsing out of a would-be fiduciary duty, the relationships that give rise to it, and the associated knowledge of a personal benefit tied to it and inferred to be pecuniary if only relational, we still find far too little federal court attention given to Rule 10b5-2. Courts have failed to adequately embrace Rule 10b5-2(b)'s standards of duties of trust or confidence and express categories of relationships giving rise to those duties notwithstanding the fact that the Commission expressly promulgated this rule to address just this issue.

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100. *See* Madden, *supra* note 3, at 68 (noting Justice Ginsburg's adoption of the government's fraud on the source theory of misappropriation as presented in its brief).

101. *See* Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1319 (2009) ("Despite the Supreme Court's explicit dictate that fiduciary principles underlie the offense of insider trading, there have been recent repeated instances in which lower federal courts and the Securities and Exchange Commission ("SEC") have disregarded these principles. On some occasions, judicial adherence to fiduciary principles would have dictated rulings in favor of defendants charged with insider trading, but courts essentially ignored those principles."). *See also*, Madden, *supra* note 2, at 70-75.

102. Selective Disclosure and Insider Trading, Exchange Act Release No. 7881 (Aug. 15, 2000); 17 C.F.R. § 240.10b5-1 (2021), *supra* note 6.

103. *Id.*

104. *Id.* (emphasis added).

105. Selective Disclosure and Insider Trading, Exchange Act Release No. 7881 (Aug. 15, 2000); 17 C.F.R. § 240.10b5-1 (2021), *supra* note 6.

106. *Id.* (emphasis added).

Any insider trading case since 2000 could have proceeded under the misappropriation theory as promulgated in Rules 10b5-1 and 10b5-2. If courts had made use of Rule 10b5-2, the relationships at issue would have been redirected from control by *Dirks*' continually varied interpretations to control by more clearly defined relationships of trust or confidence, either enumerated or principled. Moreover, if courts had made more use of Rule 10b5-2 since 2000, repeated (and repeatedly failed) attempts at legislative reform of insider trading might not have been necessary.[107]

Rule 10b5-2's duty of trust *or* confidence is itself in some distinction to the duty of trust *and* confidence tied to earlier *Chiarella* and *Dirks* precedent under Rule 10b-5, preceding the adoption of Rules 10b5-1 and 10b5-2.[108] That apparently trivial distinction is actually meaningful in parsing out the role of fiduciary duty in securities fraud not only under "classical theory" insider trading analysis, but also under the misappropriation theory of insider trading. Its repercussions affect whether the determinative duty need be a true fiduciary duty, and whether it need be comprised of care and loyalty together with confidentiality. Whether the breach of a duty of confidentiality alone is enough to meet the element is discussed further herein, *infra*.

Rule 10b5-2 "addresses the issue of when a breach of a family or other non-business relationship may give rise to liability under the misappropriation theory of insider trading."[109] The rule sets forth three non-exclusive bases for determining that "a duty of trust or confidence was owed by a person receiving information, and . . . provide[s] greater certainty and clarity on this unsettled issue."[110] Yet, again, Rule 10b5-2, while defining a duty of trust or confidence, does not mention the word "fiduciary."[111] This appears to be a logical intention to avoid the misuse and confusion of fiduciary relationships and associated terminology in *Dirks* and subsequent

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107. *See, e.g.,* Insider Trading Prohibition Act, H.R. 2534, 116th Cong. § 16A (2019) (as approved by H.R. Fin. Serv. Comm., May 8, 2019, and committed to the H. Comm. of the Whole, Sept. 27, 2019) (taking the wrongfully obtained material inside information approach advocated by Prof. Nagy); *see also* Harvey L. Pitt & Karen L. Shapiro, *The Insider Trading Proscriptions Act of 1987: A Legislative Initiative for a Sorely Needed Clarification of the Law Against Insider Trading*, 39 ALA. L. REV. 415 (1988).

108. *Chiarella*, 445 U.S. at 228; *Dirks*, 463 U.S. at 663.

109. 17 C.F.R. § 240.10b5-2 (2021), *supra* note 7.

110. [33-7881 *supra*, note 6. "As discussed in the Proposing Release [33-7887], the prohibitions against insider trading in our securities laws play an essential role in maintaining the fairness, health, and integrity of our markets. We have long recognized that the fundamental unfairness of insider trading harms not only individual investors but also the very foundations of our markets, by undermining investor confidence in the integrity of the markets. Congress, by enacting two separate laws providing enhanced penalties for insider trading, has expressed its strong support for our insider trading enforcement program. And the Supreme Court in United States v. O'Hagan has recently endorsed a key component of insider trading law, the "misappropriation" theory, as consistent with the "animating purpose" of the federal securities laws: "to insure honest securities markets and thereby promote investor confidence."

As discussed more fully in the Proposing Release, insider trading law has developed on a case-by-case basis under the antifraud provisions of the federal securities laws, primarily Section 10(b) of the Exchange Act and Rule 10b-5. As a result, from time to time there have been issues on which various courts disagreed. Rules 10b5-1 and 10b5-2 resolve two such issues."

111. *Id.*

court decisions. The fiduciary conundrum results from the misnomer of fiduciary relationships in the element of deceit which actually centers on an often reciprocal confidential relationship rather than a one directional obligation to act in the best interest of another. Rules 10b5-1 and 10b5-2 properly clarified the element by focusing on tits real essence - confidentiality. The absence of the word fiduciary in these rules should be read as the Commission's recognition that the inherently one directional obligation of an agent charged to act in the best interest of another is not where deceit turns. Deceit turns on breach of confidence, whether by silence or disclosure.

Again, Rules 10b5-1 and 10b5-2 expressly codified the fraud on the source version of the misappropriation theory adopted in Justice Ginsburg's majority opinion in *O'Hagan*.[112] The misappropriation theory extends Section 10(b) anti-fraud coverage beyond the insiders addressed by the classical theory of insider trading, supplanting the temporary insider theory previously relied upon to address tippee liability.[113] Again, neither the text of Rules 10b5-1 and 10b5-2, nor the rules' proposing release, nor the release adopting the rules, includes the word fiduciary; all are expressly principally concerned with "dut[ies] of trust or confidence" that are more accurately the real concern of the element of fraud or deceit in insider trading.[114] Proper application of these rules could have and still can lay bare the intentional or unintentional obfuscation of the fiduciary conundrum originating with Powell's *Dirks* and *Chiarella* decisions.

Yet, to date, the 2000 rules have been largely ignored. Federal cases decided under the misappropriation theory in the wake of *O'Hagan* include the Second Circuit's 2001 *United States v. Falcone*,[115] and Eleventh Circuit's 2003 *S.E.C. v. Yun*[116] Each of these cases applied and expounded upon the fraud on the source misappropriation theory adopted in Justice Ginsburg's *O'Hagan* decision.[117] *Yun* emphasized the broad applicability of the misappropriation theory and noted that the misappropriation theory logically subsumes the classical theory, as it offers means to assess duty and breach whether that duty is born by an insider or outsider.[118] While *Falcone* made

112. *See supra* text accompanying notes 6 and 7.

113. *See* Madden, *supra* note 3, at 58-65 (discussing Ginsburg's construction of the fraud on the source misappropriation theory and the key precedent of Carpenter v. United States, 484 U.S. 19 (1987) and other prior federal decisions as precursors to *O'Hagan*); *See generally* Gregory S. Crespi, *The Availability After Carpenter of Private Rights of Action under Rule 10b-5 Based Upon the Misappropriation of Information Concerning Acquisitions*, 26 AM. BUS. L.J. 710 (1988) (offering further elucidation of *Carpenter*); *See also* Prentice, *supra* note 10, at 348-9 (discussing the temporary insider theory).

114. 17 C.F.R. § 240.10b-5 (Rule 10b-5) *supra* note 7 ("It shall be unlawful for any person…(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.").

115. United States v. Falcone, 257 F.3d 226 (2d Cir. 2001).

116. SEC v. Yun, 327 F. 3d 1263 (11th Cir. 2003).

117. *Falcone*, 257 F.3d 226; *Yun*, 327 F.3d 1263.

118. *Yun*, 327 F.3d at 1276.

no reference to Rule 10b5-2, *Yun* gave the then new rule significant attention in its reasoning.[119] *Yun* relied on the Commission's justification for the rule in finding the breach of confidence in a spousal relationship as enumerated in Rule 10b5-2(b)(3) to constitute insider trading, commenting that *Chestman's* reluctance to do so was to interpret the rule too narrowly.[120] Yet, *Yun's* consideration of Rule 10b5-2 would not become a consistent norm for federal courts analyzing facts under the misappropriation theory.[121]

Five years after promulgation, in 2005, the Second Circuit eschewed Rule 10b5-2 and discussed *Chiarella*, *O'Hagan*, and *Zandford*[122] in *S.E.C. v. Dorozhko*,[123] determining that those precedents did not individually or in the aggregate require breach of duty to find a Section 10(b) violation.[124] Rather, *Dorozhko* focused on deception and fraud outside of a defined fiduciary or like relationship creating a duty.[125] *Dorozhko* also looked to the Fifth Circuit's *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, [126] for support in this reading of precedent.[127] Eight years after Rule 10b5-2's promulgation, in 2008, the Central District of California's *S.E.C. v. Talbot*, applied the misappropriation theory in considering breach of duty by a corporation's board member and ignored Rule 10b5-2. [128]

In contrast, only two years after promulgation, Judge Charles Breyer of the Northern District of California had looked to Rule 10b5-2 in *United States v. Joon Kim*.[129] The *Kim* court broke ground in applying Rule 10b5-2 even as it looked to *Chestman* for explication of the fiduciary conundrum.[130] While the *Kim* court did not rely entirely on the Rule 10b5-2, the court, similar to the Eleventh Circuit in *Yun*, noted that the rule was persuasive and expressly promulgated to sharpen the discussion of duty and breach in *Chestman*.[131]

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119. *Id.* at 1274.

120. *Id.* at 1272-73.

121. *See* Madden, *supra* note 3, at 70-74.

122. SEC v. Zandford, 535 U.S. 813 (2002) (focusing on the "in connection with" element and looking to *O'Hagan* to support the recognition of a summarily accepted fiduciary relationship between a stock broker and the broker's clients).

123. SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009).

124. *Id.* at 48.

125. *Id. See also* SEC v. Rocklage, 470 F.3d 1, 19-21 (1st Cir. 2006) (discussing a wife's deception of her husband as a source of material nonpublic information in an extended "in connection with" analysis under *O'Hagan* yet ignoring Rule 10b5-2).

126. Regents of the Univ. of Cal. V. Credit Suisse First Boston, 482 F.3d 372 (5th Cir. 2007).

127. SEC v. Dorozhko, 574 F.3d 42, 48 (2nd Cir. 2009) (citing *Regents*, 482 F.3d at 372, 389); s*ee also*, United States v. Evans, 486 F.3d 315 (7th Cir. 2007) (discussing the misappropriation theory under *O'Hagan* and looking for a breach of a duty of loyalty and confidentiality).

128. SEC v. Talbot, 430 F. Supp. 2d 1029 (C.D. Cal. 2006).

129. *Id.*

130. *Kim*, 184 F. Supp. at 1020.

131. *Id.* at 1014-15.

C. FIDUCIARY VERSUS FIDUCIARY-LIKE

In the outsider trading context, the federal courts have struggled to make sense of the place of fiduciary duty grounded in common law deceit and misrepresentation in violation of the SEC rules promulgated under Section 10(b). A number of courts have referred to "duties of trust *and* confidence," while Rules 10b5-1 and 10b5-2 have expressly sought to define "relationships of trust *or* confidence" where misappropriation of material nonpublic information might exist.[132] Yet, few court decisions since *Dirks* have explicitly illuminated fiduciary duty *per se*.

Both *O'Hagan* and *Chestman* together were the primary sources for the Commission in proposing and promulgating Rules 10b-5-1 and 10b5-2.[133] Each decision discussed fiduciary duty, though the discussion in *Chestman*[134] delved more deeply into the duty as including a "relationship of trust and confidence" that is the "functional equivalent of a fiduciary."[135] *O'Hagan* involved a classic fiduciary relationship between a lawyer and client, albeit not between a corporate insider and shareholders.[136] The functional equivalency in *Chestman* and the import of the fiduciary relationship in *O'Hagan's* fraud on the source formulation, cohere in centering on a relationship of shared confidence. This does not, however, focus on the true and unique nature of a fiduciary relationship which, again, is characterized by a one-way obligation of one party to act in the best interest of another. As discussed, *supra*, the fiduciary terminology is a function of Justice Powell's original language in *Chiarella* and *Dirks* and more accurately about relationships characterized by often reciprocal confidentiality. Perhaps "fiduciary-like" should be read as a marker for such established confidence. Some alternate terminology must be consistently adhered to by the courts if we are to resolve the fiduciary conundrum. Certainly, Rules 10b5-1 and 10b5-2 offer reasonable means to clarify the fiduciary conundrum. The rules' formulation of duties of trust or confidence may be the best route to the real focus in *Chiarella* and *Dirks* and consequently virtually all insider or outsider trading cases since.

In 2003, in *S.E.C. v. Kirch,*[137] the Northern District of Illinois considered the legality of a CEO Roundtable member's trade based on material nonpublic information that the member learned of at a Roundtable meeting.[138] The court did not reference Rule 10b5-2, but reasoned,

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132. *See*, *e.g., Kim*, 184 F. Supp. at 1010.

133. Proposed Rule: Selective Disclosure and Insider Trading No. 34-7787, Fed. Sec. L. Rep. (CCH) ¶ 82,846 (Dec. 20, 1999).

134. *Chestman*, 947 F.2d at 569.

135. United States v. Corbin, 729 F. Supp. 2d 607, 614, 616-17 (S.D.N.Y 2010).

136. *O'Hagan*, 521 U.S. 642.

137. United States SEC v. Kirch, 263 F. Supp. 2d 1144 (N.D. Ill. 2003) (the court notes somewhat similar facts in *Kim* and pointedly chooses not to be persuaded by *Kim*, 184 F. Supp. 2d at 1150-1151).

138. *Id.*

What is plain to this Court, and what it holds, is that the "duty of loyalty and confidentiality" owed by the outsider…to the person…who shared confidential information with him or her (the quoted phrase is from O'Hagan, 521 U.S. at 652) is *not limited to fiduciary relationships in the limited sense that requires such factors as control and dominance on the part of the fiduciary. Instead that "duty of loyalty and confidentiality" can be (and is) created by precisely the type of policy and expectations that are present in the Roundtable relationships here* (see the discussion in Yun, 327 F.3d at 1272-73). [139]

The facts in *Kirch* offer just the situation to which Rule 10b5-2 speaks and which so many courts have overlooked in turning back to *Dirks* and the fiduciary conundrum.[140] Rule 10b5-2 offers a clearer standard that is more in tune with the purpose of Section 10(b) and Rule 10b-5 –which it was intended to further. Rule 10b5-2(b)(2) specifically describes an enumerated duty of trust or confidence where persons have a "history, pattern, or practice of sharing confidences" such that those persons expect . . . that the recipient will maintain [that]. . . confidentiality."[141]

It is apparent that the federal courts' focus on the fraud or deceit element since *Chiarella* and *Dirks* actually turned more on the breach of duty arising from a relationship characterized by often reciprocal and established confidentiality rather than on a true fiduciary relationship of one party obligated to act in the best interest of another. The "fiduciary-like" terminology is certainly closer to reality than fiduciary duty *per se*. Rule 10b5-2 maintained this essence of confidentiality in the fraud or deceit element with the Commission's reasonable promulgation of the misappropriation theory, leaving aside the misused and problematic language of fiduciary duty *per se*. Yet, precious few courts have taken the opportunity to employ Rules 10b5-1 and 10b5-2 as a means of clarifying the law of insider and outsider trading under the misappropriation theory. Instead, court after court has continued to look back to *Dirks* and struggled with an inherently flawed fiduciary puzzle. Still, other courts have actively supported attacks on Rule 10b5-2 in an apparent rejection of the misappropriation theory.[142]

D. DISCUSSIONS OF RULE 10B5-2

Rule 10b5-1 and 10b5-2 were really all about the relationship of established confidence that courts have conflated with fiduciary duty. The Commission's drafting of the rules relied on the Second Circuit's 1991 *Chestman* decision. [143] *Chestman*, informed by *Chiarella* and *Dirks,* offers the most developed discussion of fiduciary duty, unpacking its true meaning

139. *Id.* at 1150. (emphasis added).
140. *Id.*
141. 17 C.F.R. § 240.10b5-2 (2021), *supra* note 7.
142. *See*, *e.g., Cuban,* 634 F. Supp. 2d 713.
143. United States v. Chestman, 947 F.2d 551 (2d Cir. 1991).

and its connection to other relationships of trust and confidence. Donna Nagy has asserted that the SEC via Rules 10b5-1, 10b5-2, the courts, and a shift of focus toward the wrongful use of material information, have diminished the role of fiduciary duty that *Dirks* and *Chiarella* established.[144] She, as well as others, calls for legislation to define insider trading liability, rather than leaving the door open to what she perceives will be further lower court confusion.[145]

Certain courts have made more specific use of the rules. After the Eleventh Circuit's 2003 *Yun* [146] decision made use of Rule 10b5-2, the Northern District of Texas addressed the rule in 2005 in *SEC v. Kornman*.[147] *Kornman* examined the SEC's allegations against an attorney/consultant who allegedly traded in the stock of a merger target on information learned while the attorney/consultant met with executives of the merger target.[148] The court looked to *Chestman* and the Southern District of New York's *SEC v. Cassese*[149] for guidance on whether a fiduciary duty or duty of trust and confidence had been formed between the consultant and the executive.[150] The court also looked to Rule 10b5-2(1) to find an "enumerated duty of trust or confidence" "whenever a person agrees to maintain information in confidence."[151] This provision applied because the consultant's policies required it, and the consultant had been accustomed to utilizing strict confidentiality policies and procedures, including engagement letter clauses, agreements, and memo writing which would typically be required in formalizing the relationship at issue, prohibiting any personal use of confidential information learned in the relationship.[152]

The *Kornman* court, like *Cassese*, also looked to *Kim* for explication of fiduciary duty, focusing on finding "disparate knowledge and expertise" and "a persuasive need to share confidential information."[153] Indeed, each of *Kim*, *Cassess*, and *Kornman* construe that a fiduciary-like relationship can be established by a persuasive need to share confidential information.

In denying a motion for summary judgement, the *Kornman* court reasoned further under Rule 10b5-2, "[b]ased on the allegations in the complaint, a reasonable inference can be drawn that the parties understood that a trust or confidence had been reposed . . . not to use this confidential information for personal gain." [154] Moreover, the court noted that

144. Nagy, *supra* note 9; *see*, *e.g.*, Prentice, *supra* note 10, at 372.
145. *Id.; see infra* Part II.
146. *See supra* Part II.B.
147. SEC v. Kornman, 391 F. Supp. 2d 477 *passim* (N.D. Tex., Dallas Div. 2005).
148. *Id.*
149. United States v. Cassese, 273 F. Supp. 2d 481(S.D.N.Y. 2003).
150. *Kornman*, 391 F. Supp. at 487-489.
151. 17 C.F.R. § 240.10b5-2 (2021).
152. *Kornman*, 391 F. Supp at 480-81.
153. *Kornman*, 392 F. Supp. at 488 (citing *Kim*, 184 F. Supp. 2d at 1011 and *Cassese*, 273 F. Supp. 2d at 486).
154. *Id.* at 492.

"understanding of the confidentiality can be readily inferred from the confidentiality safeguards employed by [the consultant]."[155] Thus, *Kornman* offers one of the few clear and direct applications of Rule 10b5-2, five years after the rule became effective. In addition, the court set discussion of the rule in the context of related case discussions of *Chestman* and subsequent decisions, noting *Chestman's* centrality to the rule.[156] One wonders why more courts have not done the same or more with Rule 10b5-2.

In 2009 *SEC v. Lyon*,[157] the Southern District of New York relied primarily on *Chestman* to determine whether a duty of confidence was adequately plead.[158] The creation of the duty was seen to depend in part upon knowing acceptance of a confidential relationship via confidentiality provisions included in private placement memoranda issued to prospective PIPE[159] investors. While the *Lyon* court looked to Rule 10b5-1 in its analysis of the "on the basis of" determination of the trades involved, the court made no explicit reference to Rule 10b5-2 in its consideration of a duty of trust or confidence and the breach of that duty by the defendant's trading without disclosing material nonpublic information obtained through the relationship.[160] Yet, in 2015, the Southern District of New York offered one of the most robust discussions of Rule 10b5-2 in a case brought by private right of action, *Veleron v. Stanley.*[161] *Veleron* focused on the materiality of non-public information Morgan Stanley employees had concerning a corporation, Magna, in which Veleron had invested in part with funds loaned by BNP Paribas and serviced in part by Morgan Stanley.[162] The court looked to Rule 10b5-2 to find that Morgan Stanley's contractual relationship with BNP Paribas was confidential and fiduciary-like such that non-public material information Morgan Stanley learned in the relationship could be actionable under Section 10(b) if Morgan Stanley traded on the basis of that information.[163]

1. Agreement to Maintain Confidence

Perhaps the most intense disagreement over the role of fiduciary duty in insider and outsider trading since the adoption of Rule 10b5-2(b)(1)'s

155. *Id.*
156. *Id.* at 487.
157. SEC v. Lyon, 605 F. Supp. 2d 531(S.D.N.Y. 2009).
158. *Id.* at 545-46.
159. "PIPE (Private Investment in Public Equity)".
160. *Id.* at 547-48.
161. Veleron v. Stanley, 117 F. Supp. 3d 404, 436 (S.D.N.Y. 2015) ("In Rule 10b5-2, the S.E.C. has "provide[d] a non-exclusive set of examples in which a 'duty' arises for purposes of § 10(b) and Rule 10b-5 Gansman, 657 F.3d 85, 91 (2d Cir. 2011) (citing 17 C.F.R. § 240.10b5-2 Preliminary Note; Insider Trading, U.S. Securities and Exchange 'Commission, http://www.sec.gov/answers/insider.htm ("[Rule 10b5-2] provides that a person, receiving confidential information under circumstances specified in the rule would owe a duty of trust or confidence and thus could be liable under the misappropriation theory.")) (emphasis added); accord S.E.C. v. Yun, 327 F.3d 1263, 1273 n.23 (11th Cir. 2003)").
162. *Id.* at 430-35.
163. *Id.* at 436, 440, 451-52, 455, 457.

enumerated category, "whenever a person agrees to maintain information in confidence" [164] came in the Northern District of Texas' *S.E.C. v. Cuban*.[165] This subpart was central to the much-debated battle in *Cuban* over whether Mark Cuban knowingly entered into a confidential relationship with an issuer who called to solicit his investment in a PIPE.[166] (Cuban sold his already owned shares in the public corporation after being solicited and apparently becoming fearful of dilution resulting from the planned issuance of more shares.[167])

What constitutes such an agreement to maintain confidence? Must that agreement be an express oral or written contract? Can it be implied? These considerations are particularly difficult where the trade is executed by an outsider who may have established a relationship of confidence with an insider or quasi-insider–generally a subset of the outsider trading situation, sometimes considered a "temporary insider" situation.[168]

The Fifth Circuit's reversal and remand in *S.E.C. v. Cuban*[169] centered on this very issue.[170] "Given the paucity of jurisprudence on the question of what constitutes a relationship of "trust and confidence" and the inherently fact-bound nature of determining whether such a duty exists;" the court reasoned that it would send the matter back for further discovery and retrial (which the SEC ultimately lost).[171] The Fifth Circuit refused to accept the lower court's determination that the agreement to maintain confidence described in Rule 10b5-2(b)(1) required not only an agreement to maintain confidence, but also an agreement not to trade on the material information learned in that confidence.[172]

The Northern District of Texas' *Cuban* example is favorable in that it turned to Rule 10b5-2 and grappled extensively with the rule and the duty it defines. Yet, it is problematic. It failed to find in Rule 10b5-2(b)(1) adequate clarity to determine that the confidential relationship between Mark Cuban and the issuer CEO was of the nature intended to be covered by the rule. In fact, the Northern District attacked Rule 10b5-2, finding that it improperly premised Section 10(b) liability on simple confidentiality and not

164. *See supra* text accompanying note 7.

165. SEC v. Cuban, 634 F. Supp. 2d 713, 729-31 (N.D. Tex. 2009), *vacated*, 620 F.3d 551 (5th Cir. 2010).

166. *Id.*

167. *Id.* at 717-18. (Cuban was famously quoted as allegedly saying "I'm screwed. I can't sell." upon hanging up the phone as he realized the PIPE would dilute his existing holdings in the issuer and apparently realized he should not trade on the would-be material confidential information of the pending PIPE).

168. Prentice, *supra* note 10, at 369.

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

170. *Id.* at 558.

171. *Cuban,* 620 F.3d at 558; Tom V. Ripper, *Mark Cuban Beats The SEC*, FORBES (Oct. 26 2013, 3:59 PM), https://www.forbes.com/sites/tomvanriper/2013/10/16/mark-cuban-should-be-optimistic-as-his-insider-trading-case-heads-to-the-jury/?sh=23806b561320.

172. *Id*. at 557.

confidentiality coupled with an agreement not to trade.[173] In its discussion, the Northern District dug into the usual laundry list of precedent decided long before the rule's promulgation. The court's judgement on the rule was in apparent error.[174] Yet, the Fifth Circuit maneuvered around the issue on review, leaving the direct challenge of the Rule 10b5-2 standard unresolved.[175]

2. Challenge under Chevron

In the Third Circuit's 2014 *United States v. McGee,*[176] the defendant appealed his conviction under Rule 10b5-2, in the Eastern District of Pennsylvania's 2012 *United States v. McGee,*[177] on the theory that conviction under the rule lacked the required finding of fiduciary duty under Section 10(b).[178] Thus, the battle over Rule 10b5-2 on appeal in *McGee II* focused on the relationship between an insider tipper and an outsider tippee.[179] *McGee II* considered whether a tipper-tippee relationship in which the parties were in amentor-mentee (Alcoholics Anonymous co-members) relationship creates a fiduciary duty under Rule 10(b).[180]The principal challenge to Rule 10b5-2 in *McGee II* was that the SEC had exceeded its rule-making authority and violated *Chevron* by promulgating the rule. The challenge was that deception must exist to convict under Section 10(b) and that deception in a tipper-tippee scenario requires a fiduciary duty and a breach thereof by a tippee's disclosure of material nonpublic information. [181] Writing for the Third Circuit, Aldisert found that Section 10(b) left open ambiguity as to what constitutes a "deceptive device" and that the SEC "filled the gap" in the regulation with Rule 10b5-2. [182] Indeed, the Third Circuit went on to accurately read precedent on the fiduciary conundrum, writing, "Supreme

173. *Cuban*, 634 F. Supp. 2d at 730-731; *See* Prentice, *supra* note 10, at 3 ("The trial judge [in Cuban] noted in a footnote that Rule 10b5-2(b)(1) probably extended beyond family situations, (citing *Cuban*, 634 F. Supp. 2d at 728 n.9 (citing SEC v. Nothern, 598 F. Supp. 2d 167, 174-75 (D. Mass. 2009)) but, drawing upon the same misguided distinction he had applied to the agreement-based duty not to trade, held that the extension of liability present in subsection (b)(1) was beyond the SEC's authority to promulgate because it did not require an express promise to refrain from using the information in addition to the confidentiality promise (citing Cuban at 730-31)").

174. Prentice, *supra* note 10 at 360 ("The opinion cites no authority for this proposition. It seems unlikely that there is any.").

175. *Cuban*, 620 F.3d at 657 ("The allegations, taken in their entirety, provide more than a plausible basis to find that the understanding between the CEO and Cuban was that he was not to trade, that it was more than a simple confidentiality agreement."); *see also* Andrew Verstein, *Insider Tainting: Strategic Tipping of Material Nonpublic Information*, 112 NW. U. L. REV. 725 *passim* (2018) (discussing the implications and treatment of situations similar to Cuban's).

176. United States v. McGee, 763 F.3d 304 (3d Cir. 2014).

177. United States v. McGee, 892 F. Supp. 2d 726 (E.D. Pa. 2012).

178. *McGee II*, 763 F.3d at 308.

179. *McGee II*, 763 F.3d 304 passim.

180. *Id.* at 308-09.

181. *See* Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842--843 (1984) (setting out the two step analysis of what is now known as Chevron deference).

182. *McGee II*, 763 F.3d at 313.

Court precedent does not unequivocally require a fiduciary duty for all § 10(b) nondisclosure liability. In O'Hagan, though the defendant's duty to disclose undoubtedly arose from his position as a fiduciary, the Court stressed that "This is distinct and broader than a fiduciary duty, *per se*." [183]

Moreover, Judge Aldisert noted in *McGee II* that "[t]he SEC explicitly rejected limiting liability to those who share "business confidences."[184] The SEC instead favored a facts--and-circumstances test and noted that the type of confidences historically shared between parties could be a relevant factor."[185] The *McGee II* court prudently found that the facts of the AA based mentorship and friendship in *McGee I* and *McGee II* were just what the Commission had in mind in adopting Rule 10b5-2(b)(2)–a relationship showing a pattern of shared confidence.[186] This important point supports the claim that the nature of the relationship at the heart of insider trading liability under Section 10(b) is often reciprocal and always one of established confidence, not one characterized by a one-way fiduciary obligation to act in the best interest of another.

Few courts have been so bold as Aldisert's Third Circuit in not only embracing and applying Rule 10b5-2 but in freely defending the rule's attack under *Chevron* in the wake of the *Cuban* battle and calling out the precedent on the fiduciary conundrum with clarifying accuracy and simplicity. There is no good reason to challenge the rule, which clearly passes *Chevron* muster and offers a plausible standard for the relationship giving rise to a duty of confidence at the core of deception and fraud under Section 10(b) generally. To ignore Rule 10b5-2 and to only look back again and again to the quagmire of Powell's language in *Dirks* is to willfully dispose of a solution to the fiduciary conundrum. Unlike *McGee II*, too many federal courts have done just that.

III. FIDUCIARY DUTY?

When we think of fiduciary duty, we think generally of one's positive obligation to act in the best interest of another (and the negative obligation not to act in one's self-interest as it would likely work against the interests of the fiduciary's principal or beneficiary).[187] The fiduciary relationship generally derives from some express, implied, formal or informal relationship that one has accepted or to which one's willful actions have equitably given rise. It is often constituted in the principal-agent relationship where the agent must act in the best interest of the principal, not her own. In the insider trading context, it is intuitively clear that an officer or director (or

183. *Id.* (emphasis added).

184. *Id.* at 317 (citing Proposed Rule, 64 Fed. Reg. at 72,603.)

185. *Id.*

186. *McGee II*, 763 F.3d at 317-18.

187. *See generally* Benjamin J. Richarson, *Fiduciary Relationships for Socially Responsible Investing: A Multinational Perspective*, 48 AM. BUS. L.J. 597 (2011) (providing an analysis of fiduciary relationships, albeit not specific to the securities law context).

a key informed employee) has a duty to shareholders of the corporation with which she has such a defined relationship, beyond a duty to the corporate entity itself.[188] Certainly, much state corporate law has been well-developed statutorily and in state courts to make clear and apply the duties of care and loyalty comprising such fiduciary relationships.[189] The core of the fiduciary relationship is a one-way duty to act in the best interest of another. This duty does not address relationships concerning broader, simpler, and often reciprocal confidentiality, which, notwithstanding the fiduciary conundrum, are the actual concern of Section 10(b) securities fraud.

One way to solve the fiduciary conundrum in securities fraud is to jettison any requirement to find a duty of confidence in order to convict or find liability under Section 10(b). This is Donna Nagy's suggestion upon digesting the decreasing role of fiduciary duty in federal securities fraud cases.[190] Nagy views Rule 10b5-2 as "contributing" to the "demise of fiduciary principles in insider trading."[191]

Nagy has argued that courts have inconsistently relied on the fiduciary based approaches in *Chiarella*, *Dirks*, and *O'Hagan* and that liability under section 10(b) really turns on wrongful use of confidential information with or without any fiduciary relationship and associated duty.[192] Professor Nagy is surely correct that "*Chiarella*, *Dirks*, and *O'Hagan* evidence a Supreme Court willing to stretch fiduciary principles to no small degree, when doing so facilitates a desirable policy outcome."[193] She is also correct to surmise that "the Court's methodology may well have emboldened lower courts to approach new issues with similar results-oriented reasoning."[194] To resolve the fiduciary conundrum, Professor Nagy would have us dispose of the focus on the breach of a duty under Section 10(b) in favor of a focus on the wrongful obtaining of material inside information.[195] However, casting away this essential element of securities fraud – the basis of fraud or deception – may be going too far.

Another approach, from Robert Prentice, at least in terms of Section 10(b) violations based on tippee trading, is to return to the temporary insider approach, or beef up the classical theory of insider trading, even as applied

188. *See* Nagy, *supra* note 9, at 1337-38 (for a discussion of minority/majority views on fiduciary duty and the duty of loyalty).

189. *See* Prentice, *supra* note 10, at 360-62 (discussing the inappropriate role of state law on fiduciary duty in securities fraud in the context of the Cuban case). *See generally*, Thomas M. Madden, *Do Fiduciary Duties of Managers and Members of Limited Liability Companies Exist as with Majority Shareholders in Closely Held Corporations*, 12 DUQ. BUS. L.J. 211 (2010) (discussing, *inter alia*, state law fiduciary standards in corporations outside the context of federal securities fraud).

190. Nagy, *supra* note 9 at 1340; *see also* Donna Nagy, *Beyond Dirks: Gratuitous Tipping and Insider Trading*, 42 J. CORP. L. 1 *passim* (2016) (proposing a "fraud on contemporaneous" traders version of insider trading derived from Burger's Chiarella dissent).

191. *Id.* at 1364.

192. Nagy, *supra* note 9, at 1337. *See also* Prentice, *supra* note 10, at 371-2.

193. Nagy, *supra* note 9, at 1340-41.

194. *Id.*

195. *Id.*

to outsiders.[196] To his point, Prentice has identified the key part of the problem he is offering to solve, that "[a]lthough there is technically a difference between the terms "fiduciary relationship" and "confidential relationship," the courts often use these terms interchangeably."[197] This is the heart of the fiduciary conundrum, a conflating of actually distinguished terms and meanings.

Alan Strudler and Eric Orts have attempted to sort out the fiduciary conundrum by promoting a fraud on the investor theory of Section 10(b) liability grounded in deontological moral theory.[198] Their understanding of a deontological approach centers on the view that causing harm to another constitutes moral wrong.[199] In applying deontology to the fiduciary conundrum, Strudler and Orts wrote, "[o]n our theory, one has a duty under the law of fraud to refrain from trading securities on the basis of material nonpublic information without effectively disclosing the information unless one has a superior equitable right to the information which may derive from intelligent analysis, skillful observation, or even luck."[200] This harm balancing, or calculation of the lesser harm approach, is another alternative, though it perhaps fails to elucidate the nature of the root duty to be applied to an insider or outsider trader. Strudler and Orts assert, "[w]e argue that there are good moral reasons, *even in the absence of a fiduciary relationship*, to recognize a duty to disclose in certain circumstances when people with material nonpublic information trade with those who lack such information."[201] Ultimately, Strudler and Orts propose that a fraud on the investor misappropriation theory would most accurately identify those investors harmed by securities fraud and thus best apply their deontological moral theory.[202] But in arguing that the fraud on the source version of misappropriation does not depend on a fiduciary relationship and does not identify a relevant victim of fraud, Strudler and Orts miss the more important role of confidence. It is the often reciprocal relationship of confidence captured in Rules 10b5-1 and 10b5-2 that make the fraud on the source theory work. When confidence is breached, the non-breaching party is wronged – constituting the essence of the fraud and deceit integral to Section 10(b) and Rule 10b-5.

Other approaches to reforming the law on insider trading include cost-benefit analysis, a return to parity-of-information under *Cady Roberts*,

196. Prentice, *supra* note 10, at 369 (arguing that the temporary insider approach is preferable even in the case of a misappropriator).

197. *Id.* at 374.

198. Strudler and Orts, *supra* note 9, at 387-88.

199. *Id.*

200. *See* Strudler and Orts, *supra* note 9, at 386.

201. *Id.* at 380. (emphasis added).

202. *Id.* at 398-99 (noting that this does not depend upon a fiduciary relationship and expressly returning to Burger's Chiarella dissent arguing for the fraud on the investor misappropriation theory and noting that fraud requires a relevant victim not present in the fraud on the source version of misappropriation).

general fairness, property rights analysis, duty to the marketplace and legislation imposing the same.[203]

This article contends that the fiduciary conundrum was largely solved by Rule 10b5-2 twenty years ago, but most federal courts have failed to make use of it. Rather than explicitly and consistently shifting the duty discussion under Section 10(b) to one of confidence and eschewing an analysis premised on fiduciary duty *per se*, courts have defaulted to the precedent chain going back to *Dirks,* if not *Chiarella*. This has left us with a "[t]heoretical mess."[204] This, even though Rule 10b5-2 enumerated for us twenty years ago relationships of "trust or confidence" and obviously left the fiduciary language by the wayside. One can only conclude that the Commission's logical redirection to a duty of confidence has been either willfully resisted or too often inadvertently ignored by our federal courts.

IV. RECOMMENDATIONS REGARDING RULE 10B5-2

The fraud on the source misappropriation theory can just as logically apply to insiders as to outsiders. Whether the source of the inside information is a classical insider or an outsider, the duty to the source that would exist under the classical theory would also exist under this version of the misappropriation theory. The fraud on the source version of the misappropriation theory adopted in *O'Hagan* often finds fraud in the deception by a tippee trading on material nonpublic information learned from the source without disclosing the trade to the source.[205]

Rules 10b5-1 and 10b5-2 were intended to clarify and codify the misappropriation theory.[206] These rules offered a clear and logical shift to analyze deception in securities fraud cases under a duty of confidence rather than a confused and inconsistently adhered to fiduciary duty and breach standard. They offered at least a partial solution to the fiduciary conundrum. If courts would routinely apply Rule 10b5-2 to insider and outsider trading, all instances of breach of often reciprocal relationships of confidence would be covered without the necessity of classical theory verbiage focused on a fiduciary duty owed to shareholders.

The scenarios that Rule 10b5-2 in its present form cannot address are those that do not involve established relationships of confidence, whether or not enumerated under Rule 10b5-2. Such scenarios are of two basic

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203. *See* Jill Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 219-238 (1992) (reviewing past approaches to insider trading and proposing legislation imposing a duty to the market). *See also*, Jill Fisch, *Constructive Ambiguity and Judicial Development of Insider Trading*, 71 SMU L. REV. 750 (2018) (arguing apparently to the contrary of the preceding for the benefits of judge made law via the concept of constructive ambiguity), *and* Epstein, *Returning to Common-Law Principles of Insider Trading After United States v. Newman*, 125 YALE L.J. 1482 (2016) (ultimately asserting a market efficiency motive for insider trading and advocating a diminished role for SEC oversight).

204. Strudler and Orts, s*upra* note 7, at 379.

205. *See*, *e.g.*, *Lyon*, 605 F.2d at 548.

206. 17 C.F.R. §§ 240.10b5-1 to 10b5-2.

paradigms:[207] The first exists where a trader misappropriates or steals material nonpublic information from a source with whom he lacks an established relationship of confidence. The second exists where, without deception, a trader receives, happens upon, or finds material nonpublic information from a source with whom he lacks an established relationship of confidence. The former we should care about and redress. The latter we should not. There is no good reason that an innocent finder should be prohibited from, or punished for, profiting on good luck and her own willing risk.

John Coffee has opined that "the current reach of the insider trading prohibition is both arbitrary and incomplete. Egregious cases of informational misuse are not covered, while less culpable instances of abuse are criminalized. For the long term, the scope of the insider trading prohibition needs to be better rationalized."[208] Coffee went on to propose Rules 10b5-3 and 10b5-4 to address the scenarios of theft and finding described above.[209] Coffee views his proposal in part as the codification of *Dorozhko* (finding deception under Section 10(b) without fiduciary duty) in the same vein that the SEC promulgated Rules 10b5-1 and 10b5-2, with clear *Chevron* deference.[210]

Coffee's solution generally makes sense. At the same time, however, it circumvents the essential characteristic of securities fraud, the relationship of confidence. The fiduciary conundrum has been so perplexing because, even as courts have mistermed, misinterpreted, and misapplied the nature of the often reciprocal relationship of confidence, they have been right to attend to it as an essential element of securities fraud.

Misappropriation or theft of material nonpublic information from someone with whom the misappropriator or thief has an *established* relationship of confidence is presently covered under the existing framework of Rule 10b5-2. It need only be consistently applied. Because a finder situation involves no relationship of confidence, it entails no duty nor breach of duty and no misappropriation or theft, so any trading benefit obtained by an innocent finder need not be redressed under Section 10(b). In such an instance, there simply would be no instance of fraud or deceit. It is only in situations where such a theft occurs outside of an established relationship of confidence that the current securities fraud framework of Rule 10b5-2 cannot offer redress.

Coffee is right in his proposed rules discussion and analysis of *Dorozhko*—the deception captured under Section 10(b) is broader than causing one to believe what is false or disbelieve what is true.[211] Deception, indeed, more generally entails trickery or "intentionally misleading by

207. Coffee, *supra* note 10, at 300.
208. *Id.* at 285.
209. *Id.* at 304-8.
210. *Id.* at 308.
211. *Id.*

falsehood spoken or acted."[212] So, too, fraud broadly includes cheating.[213] Note, also, that Coffee sees agency as the source of a duty of confidentiality, the breach of which is the heart of securities fraud, not the duty and breach of formal fiduciary duty *per se*.[214] Indeed, the duty of confidence is not synonymous with the fiduciary obligation to act in the best interest of another. Coffee's discussion supports this article's reading of an often reciprocal relationship of confidence being the correct focus in securities fraud— the focus that can resolve the fiduciary conundrum.

A broader notion of fraud and deceit can be captured and promulgated by the Commission in modifying existing Rule 10b5-2 to incorporate a proper understanding of the theft of material nonpublic information. Of course, the underlying wrongdoing of misappropriation is the unauthorized use of another's property.[215] Under the misappropriation theory of securities fraud, that "property" is generally material nonpublic information that would affect stock price. Theft is the *fraudulent* taking of another's property.[216] We need not go deep into property law analysis to incorporate instances of theft (incorporating the misappropriation of material nonpublic information) between or among parties lacking established relationships of confidence in order to sufficiently revise Rule 10b5-2 to capture such theft outside of relationships of confidence, such as in *Dorozhko*. We can simply add the following to the existing Rule 10b5-2.

> (c) where, notwithstanding the forgoing, a person willfully obtains material nonpublic information without consent; i.e. by theft, and that person knows or should know that the information is material and nonpublic, such theft shall constitute both (i) "fraud or deceit" and (ii) a constructive breach of a duty of trust or confidence.

This modification is true to the spirit and meaning of fraud, deceit, misappropriation, and theft. It will give courts a robust tool codified in Rules 10b5-1 and 10b5-2 as proposed to fully, clearly, and consistently solve the fiduciary conundrum. Indeed, theft includes the notion of fraud as well as the taking or use of property without consent. Liability under this addition to Rule 10b5-2 would, of course, still depend upon the thief's use of the stolen information in connection with the purchase and sale of securities. The "in connection with" component only strengthens the understanding of theft as essentially a form of fraud that breaches a constructive trust because it entails the knowing use of the information for personal benefit. Similar to Coffee's

212. BLACK'S LAW DICTIONARY 406 (6th ed. 1990) (emphasis added).

213. *Id*. at 660 ("A generic term. Embracing all multifarious means which human ingenuity can devise, and which are resorted to by one individual to get advantage over another by false suggestions or by suppression of truth, and includes all surprise, trick, cunning, dissembling, and *any unfair way by which another is cheated.*") (emphasis added).

214. Coffee, *supra* note 10, at 309-10.

215. BLACK'S LAW DICTIONARY at 998.

216. *Id*. at 1477 (emphasis added).

proposed Rules 10b5-3 and 10b5-4, this modification of Rule 10b5-2 to include a subpart (c), *supra*, can be properly accomplished by the Commission in accord with *Chevron* deference. It would fill a gap in the existing rules. More importantly, it would provide a solution to the otherwise still expanding fiduciary conundrum. It only requires our federal courts to fully apply a modified Rule 10b5-2 to all instances of alleged securities fraud where securities trades are made based upon material nonpublic information obtained via relationships of confidence which are breached. Under the proposed modified rule 10b5-2, those relationships may be established, enumerated, or constructively constituted in the act of one willfully taking the information from another without consent.

This approach would cover all instances of securities fraud foreseeable under Section 10(b), except where material nonpublic information is willingly given to and traded upon by an unknowing tippee. In that instance, the tippee would be akin to a finder and only the tipper would be liable because the tipper would be willfully breaching his duty of confidence to the information source. The modified rule would cover (i) a party breaching a relationship of confidence to an original source of material nonpublic information, and (ii) a party taking material nonpublic information without consent, which, though facts and circumstances will of course vary, spans the other actionable scenarios of Section 10(b) liability.