Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information

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The federal securities laws do not contain a definition of insider trading. As a result, case law has developed in a common law fashion from the broad statutory antifraud prohibitions. The result has been a tortuous path in defining the reach of the prohibition against trading securities on the basis of nonpublic information. This Article examines outsider trading, which occurs when market participants who are not corporate insiders obtain material nonpublic information. The Article explores the distinction between outsiders who may not and those who may enter into securities transactions on the basis of that information. SEC rulemaking has adopted a relatively broad reading of the law’s reach to deal with outsider trading. In contrast, the trend in recent cases has been to question that breadth. This Article examines recent developments and concludes that the SEC got it right. Namely, trading prohibitions properly extend “outsider trading” to certain individuals even if they are not under a fiduciary duty to keep the information confidential. The Article also explores the range of outsiders who should be covered by trading prohibitions. A final recommendation is that the confusion in the cases demonstrates that Congress should recognize the need for a statutory definition of both insider and outsider trading.

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INTRODUCTION

Federal securities regulation is designed to promote full disclosure to investors.¹ In other words, the securities laws are based on the premise that sunlight is the best disinfectant.² Full disclosure means the markets are fully informed to the extent practicable and that securities prices reflect the mix of publicly available information.³ With full disclosure as


2. This is the oft-cited phrase of Louis D. Brandeis. See Louis D. Brandeis, Other People’s Money and How the Bankers Use It 92 (1914) (“Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”); see also 1 Thomas Lee Hazen, Treatise on the Law of Securities Regulation § 1.2(3) (6th ed. 2009 & Supp. 2009).

3. The impact of disclosure on market price is captured by the efficient capital market hypothesis, which focuses on “how successful the market is in establishing security prices that reflect the ‘worth’ of the securities, success being defined in terms of whether the market incorporates all new information in its security prices in a rapid and unbiased manner.” Simon M. Keane, Stock Market Efficiency: Theory, Evidence and Implications 9 (1983); see, e.g., Jack C. Francis, Investment Analysis and Management 644-86 (1980) (discussing the efficient capital market hypothesis); James H. Lorie et al., The Stock Market: Theories and Evidence 56, 56-65 (2d ed. 1985) (same); Eugene F. Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. Fin. 383, 383 (1970) (reviewing the basis for the efficient capital market hypothesis); see also, e.g., Burton G. Malkiel, A
the basic premise of the federal securities laws, a corollary has developed that investors should have equal access to information. Trading securities on the basis of material nonpublic information gives a trader an unfair advantage over other investors that runs counter to the premise of federal securities law. Insider trading deprives investors of the level playing field that should exist in the securities markets. There are, of course, informational advantages that are legitimate. For example, if professional investors obtain superior knowledge or understanding through research or other efforts derived from publicly available information, then they can legitimately take advantage of their own efforts. It is quite another thing, however, when the informational advantage is based upon information that is not publicly available. The securities-laws trading prohibitions focus on the latter situation.

The absence of a clear definition of insider trading under federal securities law has led to hundreds of decisions grappling with the issue. Many of these decisions are confusing and inconsistent with one another. The purpose of this Article is not to add to the voluminous literature on insider trading. Instead, this Article tackles one important

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7. For a detailed discussion, see 4 HAZEN, supra note 2, § 12.17.


unresolved issue: Identifying the circumstances under which persons who are not traditional corporate insiders will be held accountable for what has become known as “outsider trading.”

Though trading by outsiders can take a handful of forms, this Article focuses on two such forms and uses the term “outsider trading” to refer to them. In particular, this Article addresses outsider trading that occurs either (1) when an investor acquires information from a company or from someone else with the expectation that the information will be kept confidential; or (2) when outsiders obtain the information through certain types of wrongful conduct, including theft. The theme uniting these forms of outsider trading is the wrongfulness of the outsider’s conduct with respect to the person or company that is the source of the information. Though information can also get into the hands of outsiders when it is wrongfully passed on to them by insiders in breach of their fiduciary duties, this Article does not consider the extent to which trading prohibitions apply to such “tipper/tippee” situations, as the relevant law covering those situations is essentially settled. Instead, this


10. Also not considered is state law of insider trading, which, although it has been applied relatively rarely, still has some vitality. See, e.g., Thomas Lee Hazen, Corporate Insider Trading: Reawakening the Common Law, 39 Wash. & Lee L. Rev. 845, 845-60 (1982).


12. The law is quite clear that tipper and tippee liability will exist when someone who is under a duty not to trade (the “tipper”) passes on the information to someone else (the “tippee”) in order to enable the tippee to take advantage of the information that the tipper could not. See Dirks v. SEC, 463 U.S. 646, 659-61 (1983) (holding that an investment adviser was not subject to liability since information was not passed on for the purpose of trading); United States v. Carpenter, 791 F.2d 1024, 1036 (2d Cir. 1986) (affirming conviction of newspaper reporter who passed on material information about upcoming columns; the reporter as a nontrading tipper and his tippees who traded were convicted for having violated Rule 10b-5, aff’d by an equally divided court, 484 U.S. 19, 27-28 (1987); see also United States v. Falcone, 257 F.3d 226, 234-35 (2d Cir. 2001) (holding that knowledge of tipper’s breach of duty supported tippee’s conviction); United States v. McDermott, 245 F.3d 133, 138-39 (2d Cir. 2001) (liability based on tip of information between paramours); United States v. Ruggiero, 55 F.3d 647, 649 (5th Cir. 1995) (upholding conviction of tippee of corporate insider); SEC v. Palermo, No. 99CIV 10067, 2001 WL 1160612, at *7 (S.D.N.Y. Oct. 2, 2001) (holding that questions of fact
Article explores recent cases applying federal trading prohibitions to the two forms of outsider trading identified above, and seeks to provide a measure of clarity in this unsettled area of law.

Instances of outsider trading have received publicity and notoriety over the years. For example, Martha Stewart's legal problems stemmed from an insider trading investigation. Defendants in outsider trading cases have included a wide range of people, including psychiatrists, football coaches, former athletes, other high profile sports figures, adult film stars, newspaper columnists, printers, leading arbitrageurs, golfing partners, and lawyers.


13. Ms. Stewart was prosecuted for obstruction of justice and lying to investigators in connection with an insider trading investigation. See Scott Turow, Cry No Tears for Martha Stewart, N.Y. TIMES, May 27, 2004, at A29. The investigation involved sales of a pharmaceutical company's stock by members of the CEO's family in advance of bad news from the FDA about a company product. Id. Ms. Stewart also sold shares in advance of public disclosure of the unannounced bad news. Id. Insider trading charges would have been very difficult to establish in her case. See United States v. Stewart, 305 F. Supp. 2d 368, 370 (S.D.N.Y. 2004) (judgment of acquittal on securities fraud charge); see also, e.g., Joan MacLeod Heminway, Martha Stewart Saved! Insider Violations of Rule 10b-5 for Misrepresented or Undisclosed Personal Facts, 65 Md. L. Rev. 380 (2006) (discussing the Martha Stewart case).


At one time, the cases interpreting federal law took a broad view of who is covered by outsider trading prohibitions. Basically, anyone in possession of material nonpublic information, whether outsider or insider, was thought to be barred from using that information to trade securities. However, the Supreme Court in Chiarella v. United States subsequently held that such a broad definition of prohibited trading was not supported by the applicable statute, Securities Exchange Act section 10(b). Instead, the Court ruled that liability must be premised on fraud, deception, breach of duty, or possibly other wrongful conduct. Thus, post-Chiarella, trading while in mere possession of material nonpublic information would no longer be sufficient to trigger liability. Although Chiarella thereby limited the scope of outsider (and insider) trading liability under section 10(b), outsider trading prohibitions nevertheless remained viable under “appropriate circumstances.” However, in the absence of specific guidance from the Court, the “appropriate circumstances” giving rise to outsider trading liability remained unclear. As a consequence, confusing and often inconsistent case law followed in the circuit and district courts.

In response, the SEC adopted Rule 10b5-2 in an attempt to provide more certainty in identifying relationships and situations when
outsiders could be placed under trading prohibitions. The SEC in Rule 10b-5-2 took a broad, and justifiable, view of the law's reach with respect to corporate outsiders. Yet the trend in recent cases has been to question the validity of the SEC's view of outsider trading liability.

The timing of this Article is triggered by two recent decisions focusing on the scope of outsider liability for trading on material nonpublic information. Both decisions represent partial victories for the SEC in its relatively broad view of outsider trading. However, the cases also take too narrow a view of the reach of section 10(b) and Rule 10b-5. This Article concludes that the SEC in Rule 10b-5-2 takes a proper view and that many of the recent cases take an overly restrictive view of what the statute permits. The Article also suggests that a statutory definition of prohibited insider and outsider trading is long overdue.

The Parts that follow begin with an overview of the development of insider trading law under Rule 10b-5. This is followed by a discussion of SEC Rule 10b-5-2 that attempts to give certainty in defining the scope of outsider trading. Next, the Article analyzes the most recent cases and points out where they went wrong and what they got right. The discussion then goes beyond existing law and concludes with a recommendation for a legislative solution.

I. An Overview of the Basis of Insider Trading Liability Under Rule 10b-5

The federal securities laws' primary weapon against insider trading is the general antifraud Rule 10b-5. Rule 10b-5 was adopted in 1942

31. 17 C.F.R. § 240.10b-5-2 (setting forth situations and relationships that trigger the duty not to trade on undisclosed material nonpublic information).
32. See SEC v. Yun, 327 F.3d 1263, 1273–74 (11th Cir. 2003) (affirming lower court's determination whether communications between spouses were confidential was a jury question, where jury found that postnuptial negotiations created confidential relationship so as to support insider trading liability based on a tip of information between husband and wife, but vacating for new trial on other grounds); United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991) (en banc) (holding that interspousal communication did not trigger Rule 10b-5 liability for insider trading); SEC v. Cuban, 634 F. Supp. 2d. 713, 730–31 (N.D. Tex. 2009) (holding that confidentiality agreement did not support Rule 10b-5 violation where defendant traded on the basis of nonpublic information); United States v. Kim, 184 F. Supp. 2d 1006, 1014 (N.D. Cal. 2002) (holding mutual expectation of confidentiality did not support Rule 10b-5 violation where defendant traded on the basis of nonpublic information); see also Donna M. Nagy, Insider Trading and the Gradual Demise of Fiduciary Principles, 94 Iowa L. Rev. 1315, 1353–57 (2009) (claiming, among other things, that the current SEC view goes beyond what is permitted by controlling Supreme Court precedent).
33. See Cuban, 634 F. Supp. 2d. at 730–31 (holding that confidentiality agreement did not support liability for insider trading); SEC v. Dorozhko, 574 F.3d 42, 49–51 (2d Cir. 2009) (finding that hacker could be liable if theft was procured through a misrepresentation).
34. For more detailed discussion of the basis of insider trading liability, see supra note 5 and accompanying text.
35. 17 C.F.R. § 240.10b-5. Rule 10b-5, which has not been amended since its adoption in 1942, states:
under the rulemaking authority granted to the SEC by section 10(b) of the Securities Exchange Act of 1934. The rule was enacted without significant deliberation and does not even mention insider trading. As

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Id.

36. 15 U.S.C. § 78j(b) (2006 & Supp. 2008) ("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 . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.").

37. According to the account provided by Milton Freeman:

It was one day in the year 1943, I believe [in fact, it was 1942]. I was sitting in my office in the S.E.C. building in Philadelphia and I received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, "I have just been on the telephone with Paul Rowen," who was then the S.E.C. Regional Administrator in Boston. "and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at $4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be $2.00 a share for this coming year. Is there anything we can do about it?" So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where "in connection with the purchase or sale" should be, and we decided it should be at the end.

We called the Commission and we got on the calendar, and I don't remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said. "Well," he said, "we are against fraud, aren't we?" That is how it happened.


38. By contrast, section 16 of the Securities Exchange Act does address trading by certain corporate insiders. See 15 U.S.C. § 78p. However, that section is not addressed to insider trading as that term is generally understood by the public. Section 16(a) requires officers, directors, and ten percent beneficial owners of a public company's stock to report all of their transactions in shares. Id. § 78(p)(a). Section 16(b) requires disgorgement of short-swing profits (within a six-month period) by those statutory insiders, regardless of whether they relied on material nonpublic inside information in making those trades. Id. § 78p(b). Section 16 is a prophylactic remedy designed to prevent certain
a general antifraud rule, it prohibits more trading-related wrongdoing than just insider trading. For example, it creates liability for misrepresentations to the investing public. Experience has shown, however, that we would be better served by a clear statutory definition of insider trading, setting forth specific limits on trading while in possession of material nonpublic information. Although Congress came close to a definition in 1984, there has been no significant attempt since. Without a statutory definition on the horizon, the courts will continue to muddle through the tortuous path of Rule 10b-5 liability for insider trading.

Rule 10b-5 is generally acknowledged as designed to prevent fraud and deception in connection with securities trades. However, the evils of insider trading go beyond fraud. Insider trading gives an unfair advantage to some market participants and can shake investor confidence in the securities markets. Therefore, dealing with insider trading through an antifraud rule is like trying to fit a square peg into a round hole. But since this problem has not been addressed through a statutory solution, the courts have little choice other than to struggle with Rule 10b-5 and its parent, section 10(b).

Though federal securities law is statutory in nature (and thus technically speaking has not been derived by courts as a matter of common law), the law of insider trading has an essentially common-law character. This is because the law is not spelled out with particularity in the statute or SEC rules, but rather is found in the case law. Accordingly,
insider and outsider trading law has developed through courts adapting insider trading prohibitions to section 10(b)’s and Rule 10b-5’s broadly worded fraud and deception limitations, much in the same manner as common law evolves—i.e., on a case-by-case basis. This has led to an imperfect and uneven federal law of insider and outsider trading. For example, a stockbroker trading on nonpublic information that had been supplied by his customer was exonerated on facts very similar to those sufficient to hold a psychiatrist liable for trading on information supplied by a patient.

Trading on inside information can occur in various contexts. First, there is what is often referred to as “classical” insider trading, which consists of those instances in which a true company insider, such as an officer or director, trades on nonpublic information she acquired as a result of her special and fiduciary position with the company. Second, there are cases where an insider passes on this information to someone else—referred to as “tipper/tippee” liability. Finally, as noted above, there are those instances often referred to as “outsider” trading, where someone who does not have a special relationship to the company acquires information about the company and improperly trades on that information; these are most often referred to as the “misappropriation” cases.

The law prohibiting classical insider trading by company insiders is relatively straightforward. A company insider who is in possession of material nonpublic information about her company is subject to what is

43. United States v. Chestman, 947 F.2d 551, 565-66 (2d Cir. 1991) (holding that stock broker who traded on nonpublic information provided by customer did not violate Rule 10b-5); see Thomas Lee Hazen, United States v. Chestman—Trading in Securities on the Basis of Nonpublic Information in Advance of a Tender Offer, 45 Brook. L. Rev. 595 (1991) (discussing the Chestman decision). There was evidence that when the customer called his broker to trade on the inside information, the broker told the customer that that would be illegal but the broker nevertheless went ahead and traded on the information. Id. at 604.

44. SEC v. Willis, 825 F. Supp. 617 (S.D.N.Y. 1993) (misappropriation by broker of psychiatrist, who had misappropriated information from patient). The court relied on the confidentiality imposed by the doctor-patient relationship. See id. at 622. It seems anomalous to interpret the securities laws to give more weight to the doctor-patient relationship than to a stockbroker-customer relationship, especially since stockbrokers are heavily regulated by the Securities Exchange Act. See 15 U.S.C. § 78d (2006) (broker-dealer registration requirements and prohibited practices). In contrast to Chestman, the patient in Willis did not pass on the information for the purpose of trading. See Willis, 825 F. Supp. at 618–23. This is probably not a significant distinction since in the Chestman case, there was evidence that the broker advised the customer that the customer could not trade because of insider trading prohibitions, and thus the broker was not trading with the customer’s permission.

45. See, e.g., Tex. Gulf Sulphur, 401 F.2d at 833 (involving not only classical insider trading by true insiders but also trading by persons who had been tipped with the nonpublic information).

46. See, e.g., Dirks v. SEC, 463 U.S. 646, 654–55 (1983) (discussing the scope of tipper/tippee liability); see also supra note 12 and accompanying text.

47. See supra note 11.

generally described as the "disclose or abstain" rule.⁴⁹ Although the disclose or abstain rule is phrased in the alternative, rarely, if ever, is disclosure a viable alternative.⁵⁰ Accordingly, the rule boils down to a duty to abstain from trading until the company or other rightful owner of the information makes a decision to disclose it and the information has been digested by the market.⁵¹

The disclose or abstain rule was derived from subsection (c) of Rule 10b-5, which prohibits conduct "which operates or would operate as a fraud or deceit."⁵² As noted above, Rule 10b-5 liability is premised on misuse of information that is not available to the general investing public.⁵³ If trading by the insider takes place prior to the filtration of information into the securities markets, other market participants who rely on the integrity of the markets and the federal disclosure requirements have been deceived. In other words, those investors have been deceived by the inequality of information. Hence insider trading can "operate as a fraud or deceit," as is required to establish a Rule 10b-5(c) violation.⁵⁴

Because liability is premised on Rule 10b-5, the SEC or a private plaintiff trying to prevail on an insider trading claim must necessarily establish the elements necessary for any violation of the rule. These elements include materiality and scienter.⁵⁵ Thus, it must be established

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⁴⁹. See Tex. Gulf Sulphur, 401 F.2d at 833, 848 (holding that corporate insiders and their tippees were subject to SEC enforcement action for trading on material nonpublic information); ⁴ Hazen, supra note 2. As discussed above, this early application of the disclose or abstain rule was significantly modified by the Supreme Court in Chiarella v. United States, 445 U.S. 222, 223-24 (1980), which overturned the conviction of a financial printer's employee based on knowingly trading while in possession of material nonpublic information. Though Chiarella overturned certain aspects of the Texas Gulf Sulphur holding, the aspects of the holding that remain unmodified demonstrate that the law prohibiting classical insider trading by insiders is well-settled and straightforward. Cf. In re Cady, Roberts & Co., 40 S.E.C. 907 (1961) (stock broker sanctioned for passing material inside information on to customers); Donald C. Langevoort, Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation, 99 Colum. L. Rev. 1319, 1322 n.15 (1999).

⁵⁰. Ordinarily, it will be up to the company and its management to decide when to disclose nonpublic information. An insider who prematurely discloses this information to enable a trade would be acting for selfish purposes rather than in the interests of the company that entrusted the insider with the information, and thus could face liability for such disclosure. Cf. Diamond v. Oreamuno, 248 N.E.2d 910 (N.Y. 1969) (holding that corporate insiders cannot use confidential information for their own advantage); Brophy v. Cities Serv. Co., 70 A.2d 5 (Del. 1949) (same); accord In re ORFA Sec. Litig., 654 F. Supp. 1449 (D.N.J. 1987).

⁵¹. See, e.g., Tex. Gulf Sulphur, 401 F.2d at 833 (discussing when insiders may trade after the information has been disclosed).

⁵². 17 C.F.R. § 240.10(b)(5)(c) (2009); see also, e.g., O'Hagan, 521 U.S. 642; Tex. Gulf Sulphur, 401 F.2d 833; In re Cady, 40 S.E.C. 907.

⁵³. An issue not addressed in this Article is the extent to which someone who obtains the information from an insider can be guilty of insider trading. See Dirks v. SEC, 463 U.S. 646 (1983); 4 Hazen, supra note 2, § 12.17(5); see also supra note 9.

⁵⁴. 17 C.F.R. § 240.10(b)5.

⁵⁵. SEC v. MacDonald, 699 F.2d 47, 50 (1st Cir. 1983).
that the nonpublic information was "material." Materiality is a concept borrowed from common law fraud for determining which misstatements are actionable and which are not. A fact is material if, considering the total mix of publicly available information, there is "a substantial likelihood that a reasonable shareholder would consider it important." In addition, the defendant must have acted with the intent to deceive, or "scienter," another concept borrowed from the common law, which is generally interpreted to include severely reckless conduct.

In contrast to the relatively straightforward nature of classical insider trading, the law of outsider trading is both complex and confusing. The next Part addresses the puzzle of identifying those persons who are subject to Rule 10b-5's disclose or abstain rule, on the basis that they misappropriated or otherwise wrongfully obtained and used the information in making securities trades.

II. THE MISAPPROPRIATION THEORY AND RULE 10b-5-2

A. CHIARELLA AND EARLY MISAPPROPRIATION THEORY

Notwithstanding prior case law to the contrary, the Supreme Court in Chiarella held that there is no duty to disclose—and hence no prohibition on trading—based solely on the possession of material nonpublic inside information. The Court reasoned that in the absence of a wrongful conversion or misappropriation of the information, no requisite fraud or deception has occurred within the meaning of section 10(b), since traders in securities have no general duty to disclose material

56. "For the securities lawyer, 'materiality' is the name of the game." Richard W. Jennings & Harold Marsh, Jr., Securities Regulation: Cases and Materials 1023–25 (5th ed. 1982); see Tex. Gulf Sulphur, 401 F.2d at 848 (discussing materiality in the context of an insider trading case); see also Basic Inc. v. Levinson, 485 U.S. 224 (1988) (accepting the Texas Gulf Sulphur approach to materiality in a case that did not involve insider trading).


60. See Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 327 (2007) (discussing proof of scienter); Aaron v. SEC, 446 U.S. 680, 701–02 (1980) (the scienter requirement applies to both private and SEC enforcement actions); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976) (holding that scienter is an element of a Rule 10b-5 violation; reserving the question of whether reckless conduct is sufficient); see also 4 Hazen, supra note 2, § 12.8(3).

61. Thousands of pages have been written on the scope of insider trading liability and the misappropriation theory in particular. A rehash of the development is beyond the scope of this Article. For a complete discussion of the evolution of the misappropriation theory, see 4 Hazen, supra note 2, § 12.17(4).

nonpublic information prior to trading.63 Consequently, by itself, trading on the basis of such information is not sufficient to establish a violation of section 10(b) (nor, it follows, of Rule 10b-5). Instead, liability for outsider trading requires something more.64 Thus, for example, after Chiarella it became clear that someone who simply overhears confidential material information is free to trade on it.65

But though the Court in Chiarella rejected outsider trading liability based on nothing more than trading while in possession of material nonpublic information, the Court explicitly left open whether a different theory could have sustained Mr. Chiarella’s conviction. Though the issue was not before it, the Court suggested in dicta that Mr. Chiarella’s employment relationship could create a duty to his employer not to misappropriate confidential information learned in the course of his employment, a necessary adjunct of such a duty being the duty not to trade on such information.66 This came to be known as the “misappropriation theory” of 10b-5 liability for trading on confidential nonpublic information.

In the years following Chiarella, several federal courts of appeals adopted the misappropriation theory.67 When the Fourth68 and Eighth69

63. Id. at 231–35; see also Feldman v. Simkins Indus., Inc., 679 F.2d 1299, 1303–04 (9th Cir. 1982) (defendant owning the largest single block of stock, but not a controlling interest, had no duty to disclose under Chiarella); cf. Arst v. Stifel Nicolaus & Co., 871 F. Supp. 1370, 1384 (D. Kan. 1994) (holding that broker did not have a fiduciary relationship with customer so as to impose on the broker a duty to disclose information about securities customer wanted to sell), aff’d in part, rev’d in part, 86 F.3d 973, 979 (10th Cir. 1996) (holding that broker breached his fiduciary duty by failing to disclose purchases on his own account and thus was not entitled to summary judgment on that claim).

64. But cf. 17 C.F.R. § 240.14e-3 (2009) (prohibiting trading in advance of announced tender offers and purporting to apply to any person other than the person making the tender offer regardless of a special duty or relationship); United States v. Chestman, 947 F.2d 551, 571 (2d Cir. 1991) (upholding conviction for violating Rule 14e-3 but finding no 10b-5 violation due to the absence of a duty); United States v. O’Hagan, 521 U.S. 642, 675–76 (1997) (upholding Rule 14e-3 but not deciding whether it could be violated without a duty sufficient to violate Rule 10b-5).


68. United States v. Bryan, 58 F.3d 933, 936 (4th Cir. 1995) (overturning securities fraud conviction based on misappropriation of nonpublic information); United States v. ReBrook, III, 58
Circuits subsequently rejected it, the stage was set for the Supreme Court to resolve the split, which it did in *United States v. O'Hagan* by adopting the theory. The essence of the misappropriation theory is the existence of a fiduciary or other relationship that imposes a duty not to trade on confidential information obtained by reason of such relationship. The existence of that duty triggers the concomitant disclose or abstain obligation, violation of which results in trading liability. The relevant decisions reveal serious problems in trying to identify the relationships sufficient to implicate the misappropriation theory.

B. THE SEC’S RESPONSE: RULE 10b5-2

The misappropriation cases provided a case-by-case rather than systematic analysis of the scope of the misappropriation theory of outsider trading liability. In 1999, the SEC proposed Rule 10b5-2 to establish a nonexclusive rule as to the scope of misappropriation liability. The rule was adopted in 2000. Under Rule 10b5-2, there are three non-exclusive bases for determining that a duty of trust or confidence was owed by a person receiving information: (1) when the person agreed to keep information confidential; (2) when the persons involved in the communication had a history, pattern, or practice of sharing confidences that resulted in a reasonable expectation of confidentiality; and (3) when the person who provided the information was a spouse, parent, child, or sibling of the person who received the information, unless it were shown affirmatively, based on the facts and circumstances of that family relationship, that there was no reasonable expectation of confidentiality.

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71. Not every misuse of information will constitute a Rule 10b-5 violation. Thus, for example, as discussed below, it has been held that straight theft of information without a breach of fiduciary duty will not constitute a Rule 10b-5 duty to disclose or abstain from trading. See *SEC v. Dorozhko*, 574 F.3d 42, 49 (2d Cir. 2009).


This section provides a non-exclusive definition of circumstances in which a person has a
A number of cases have questioned the breadth of the SEC's rule. In dicta, the Eleventh Circuit in SEC v. Yun questioned Rule 10b5-2(b)(3)'s provision that marriage creates a presumption of a disclose or abstain obligation emanating from spousal communications. Nevertheless, the court went on to hold that family relationships can provide the basis for a confidential relationship sufficient to trigger insider trading liability. A subsequent First Circuit decision found that confidences passed on from one spouse to another are clothed with a duty of trust or confidence for purposes of the "misappropriation" theory of insider trading under Section 10(b) of the Act and Rule 10b-5. 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 section shall apply to any violation of Section 10(b) of the Act and § 240.10b-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 section, 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.

17 C.F.R. § 240.10b5-2 (citation omitted).

75. SEC v. Yun, 327 F.3d 1263, 1271–74 (11th Cir. 2003). Although the case was not governed by Rule 10b5-2, the court rejected a presumption that the marriage relationship creates a Rule 10b-5 duty. The court noted that "the SEC's new rule goes farther than we do in finding a relationship of trust and confidence (e.g., the new rule creates a presumption of a relationship of trust and confidentiality in the case of close family members)," but found that prior case law did not go that far. Id. at 1273 n.23. Since the SEC cannot by rule extend the scope of the section 10(b) beyond what Congress intended, it would seem to follow that in the court's view Rule 10b5-2 exceeds the scope of the statute.

76. Id. at 1263 (affirming lower court's determination that the confidentiality of communications between spouses was a jury question, where jury found that postnuptial negotiations created confidential relationship so as to support insider trading liability based on a tip of information between husband and wife, but vacating for new trial on other grounds); see also Ray J. Grzebielski, Friends, Family, Fiduciaries: Personal Relationships as a Basis for Insider Trading Violations, 51 CATH. U. L. REV. 467 (2002); Thomas M. Madden, O'Hagan, 10b5-2, Relationships and Duties, 4 HASTINGS BUS. L.J. 55 (2008).
duty of confidentiality sufficient to establish a Rule 10b-5 disclose or abstain obligation.  

Rule 10b5-2 has fared less well in the district courts. In United States v. Kim, a federal district court in California implicitly raised the question of whether Rule 10b5-2(b)(2) went too far in finding a duty based on a mutual expectation of confidentiality that fell short of a binding agreement. More recently, a federal district court in SEC v. Cuban, which is discussed more fully below, questioned subsection (b)(1) when it held that a confidentiality agreement regarding material nonpublic information does not by itself necessarily support a Rule 10b-5 duty to disclose or abstain from trading.

Notwithstanding the questions raised by the foregoing decisions, Rule 10b5-2 has not been invalidated. It thus remains a force to be reckoned with. Unless the rule is stricken by a court or rescinded by the SEC, people conducting transactions with access to nonpublic information must be mindful of the three situations in which a duty of confidentiality is presumed under the rule. It is also important to note that although Rule 10b5-2 clarifies three situations in which the misappropriation theory applies, it does not preclude finding a duty of confidentiality in other situations as well. Indeed, Rule 10b5-2 is nonexclusive and continues to serve as a basis for identifying additional circumstances and relationships sufficient to trigger Rule 10b-5 duties.

As noted above, Rule 10b5-2 establishes a bright-line rule under which the receipt of information from a spouse, parent, child, or sibling will provide a sufficient basis for presuming outsider trading liability, assuming that all other elements are satisfied. The rule further includes

77. SEC. v. Rocklage, 470 F.3d 1, 13-14 (2006) (finding that wife breached duty to her husband when she obtained nonpublic information with the intention to pass it on to her brother so he could trade on it to his advantage).

78. 184 F. Supp. 2d 1006 (N.D. Cal. 2002). In Kim, the defendant was a member of a national organization, the Young Presidents Organization, whose principles expressly stated: "We operate in an atmosphere of absolute confidentiality. Nothing discussed in forum will be discussed with outsiders. Confidentiality, in all ways and for always." Id. at 1008. The defendant traded on the basis of information in violation of this pattern and mutual expectation of confidentiality. Id. at 1008-09. The court held that this was not sufficient to support liability under Rule 10b-5. Id. at 1015. The decision did not directly rule on the validity of Rule 10b5-2(b)(2) since the facts of the case arose prior to the rule’s effective date. Nevertheless, the court questioned the rule’s validity. Id. at 1014-15. Furthermore, if the court was correct that dismissal was mandated by the terms of section 10(b), then Rule 10b5-2(b)(2) is overbroad since the SEC cannot by rule extend the scope of the statute.


80. See infra Part III.B.

81. See Cuban, 634 F. Supp. 2d at 726.

82. See, e.g., Kim, 184 F. Supp. 2d 1011 ("[T]he primary essential characteristic of the fiduciary relation is some measure of superiority, dominance, or control.").

83. 17 C.F.R. § 240.10b5-2(b)(3) (2009); see supra Part I (discussing the other elements of a Rule 10b-5 violation); see also SEC v. Yun, 327 F.3d 1263 (11th Cir. 2003) (affirming lower court’s determination whether communications between spouses were confidential was a jury question, where
an affirmative defense that permits the family member to rebut the presumption that a duty of confidence exists by showing that he or she did not know, and reasonably should not have known, that the insider-family member communicating the information had an expectation of confidentiality.\footnote{84}

The bright-line test that Rule 10b5-2 purports to establish has been seriously clouded by the two district court decisions noted above. In particular, the \textit{Kim}\footnote{85} and \textit{Cuban}\footnote{86} cases question Rule 10b5-2(b)(2)'s inclusion of a pattern or history of an expectation of confidentiality; those cases suggested that such a provision was beyond the scope of section 10(b).\footnote{87} The \textit{Cuban} case also indicates that not all confidentiality agreements will necessarily encompass a nonuse agreement sufficient to fall within the rule.\footnote{88} We must await further judicial clarification of the issues raised in those cases before being able to judge whether the courts will in fact recognize the proper breadth of Rule 10b5-2.\footnote{89}

\section*{C. Rule 10b5-2 Liability Based on Misrepresentation}

The foregoing cases address the situations and relationships that can create a duty not to trade based on an expectation of confidentiality. As discussed above, Rule 10b5-2 sets forth a nonexclusive list of situations and relationships creating such a duty on that basis. Yet there is another way of looking at trading restrictions in the context of confidentiality agreements, \textit{Kim}-style confidentiality understandings, or the marriage relationship. Rule 10b-5 clearly covers trading on material nonpublic information when that information is acquired by means of an intentionally deceptive misrepresentation.\footnote{89} Therefore, outsider liability may be premised on an outsider's \textit{wrongful misrepresentation} as a means of obtaining the information, \textit{regardless of the outsider's relationship with the source of the information}, fiduciary or otherwise.

\begin{footnotesize}
\footnote{84. 17 C.F.R. § 240.10b5-2(b)(3).}
\footnote{85. 173 F. Supp. 2d at 1035.}
\footnote{86. 634 F. Supp. 2d at 717.}
\footnote{87. 15 U.S.C. § 78j(b) (2006 & Supp. 2008); cf. \textit{Yun}, 327 F.3d at 1263 (holding that it was a jury question whether interspousal communication triggered the disclose-or-abstain obligation).}
\footnote{88. 634 F. Supp. 2d at 726.}
\footnote{89. \textit{See} Martin Flumenbaum & Brad S. Karp, \textit{Fiduciary Duty and 'Deceptive' Fraudulent Conduct Under Rule 10b-5}, N.Y.L.J., Aug. 31, 2009, at 2 col. 3 ("Given the split on this issue with the Fifth Circuit, it is possible that the Supreme Court will review this issue in the near future.").}
\footnote{90. \textit{See}, e.g., SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009); \textit{infra} Part III.A (discussing \textit{Dorozhko}). \textit{See generally} Schreiber v. Burlington N., Inc., 472 U.S. 1 (1985) (discussing the deception requirement); Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (discussing Rule 10b-5's deception requirement).}
\end{footnotesize}
With respect to confidentiality or non-disclosure agreements, the signing of such an agreement constitutes a representation as to how that information will be treated. The person who then trades on the information has in effect misrepresented his or her intent in order to obtain the information, and that misrepresentation is sufficient to trigger Rule 10b-5 obligations.\(^9\)

A similar analysis holds true for situations like that in *Kim*. In *Kim*, the defendant participated in a business association of young executives in which membership was subject to an understanding that all conversations and information related thereto remained confidential.\(^9\)

Mr. Kim’s participation in the organization and assent to those principles meant that any information obtained at the meeting was acquired because of his representation regarding confidentiality. The information that Mr. Kim traded on was thus acquired through a misrepresentation of confidentiality.

Finally, this misrepresentation analysis also applies in the context of spousal or other family communications covered by Rule 10b5-2. Even without an express confidentiality agreement, an implied representation of confidentiality should be seen as arising out of a continuing “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.”\(^9\)

A shared expectation of confidentiality should be sufficient. A misrepresentation analysis thus supports the breadth of Rule 10b5-2.

### III. *Dorozhko, Cuban, and the Scope of Rule 10b-5*

Notwithstanding Rule 10b5-2’s reasoned explication of the relationship required to trigger outsider trading prohibitions, the recent cases noted above\(^9\) and several law professors\(^9\) have questioned the rule’s validity. A closer look at the most recent cases sheds further light on the proper interpretation of Rule 10b-5 in outsider trading cases and also helps demonstrate that the Rule struck a proper balance within the bounds of the statute. The following two cases represent ill-advised partial defeats for the SEC. Courts in subsequent cases should learn from

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91. *Supra* note 90.
92. See 184 F. Supp. 2d 1006 (N.D. Cal. 2002); *supra* note 78.
94. *See supra* notes 87–92.
95. See, e.g., Brief of Amici Curiae in Support of Defendant’s Motion to Dismiss, SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009) (No. 3:08-cv-02050) (arguing for the invalidity of Rule 10b5-2 on the grounds that a confidentiality agreement is not sufficient since section 10(b) requires a fiduciary or similar duty); *see also* Nagy, *supra* note 32 (written prior to the most recent *Dorozhko* and *Cuban* decisions and positing that a fiduciary duty is required by the controlling Supreme Court cases).
the SEC's partial victories in these two cases and should also reconsider the issues on which the SEC did not prevail.

A. SEC v. Dorozhko

A federal district court in New York held that a computer hacker who broke into a company's files did not violate Rule 10b-5. The court noted its surprise that the SEC took the case, rather than passing it on to the Department of Justice for prosecution on the basis of something other than the securities laws. In finding the absence of a securities law violation, the district court reasoned that Rule 10b-5 requires some basis for imposing a "disclose or abstain" obligation based on the existence of some duty and it found that none existed on the facts before the court.

96. SEC v. Dorozhko, 606 F. Supp. 2d 321, 321-22 (S.D.N.Y. 2008) (holding that defendant who obtained information by illegally hacking into computer file did not owe a fiduciary duty of nondisclosure and thus was not in violation of Rule 10b-5 when he traded stocks based on the illegally obtained information; suggesting that the defendant could have been prosecuted for crimes not involving the securities laws or insider trading), rev'd, 574 F.3d 42 (2d Cir. 2009); see Alan R. Kaufman & James M. Keneally, Theft of Information and Securities Laws, N.Y.L.J., Jan. 24, 2008, at 4 col. 4; see also United States v. Finnerty, 474 F. Supp. 2d 530, 543 (S.D.N.Y. 2007) ("As the Supreme Court has made clear... theft by itself does not constitute securities fraud because of the requirement of deception. Indeed, theft constitutes securities fraud only when it is accompanied by a violation of fiduciary duty." (citation omitted) (citing SEC v. Zandford, 535 U.S. 813, 825 n.4 (2002))).

97. In Dorozhko, the court stated:

This case highlights a potential gap arising from a reliance on fiduciary principles in the legal analysis that courts have employed to define insider trading, and courts' stated goal of preserving equitable markets. Yet, on further consideration, the gap is not as troublesome as it may appear, since the government retains ample methods of combating inequitable practices of the kind alleged here. Indeed, we would not have to address the tension between the fiduciary requirement and the goal of preserving fair and open markets had the SEC acted on this Court's suggestion at the November 28, 2007 preliminary injunction hearing that a way to avoid a decision that would result in the release of the restrained trading proceeds was to refer this matter to the United States Attorney's Office for criminal investigation. Based on the evidence provided at the November 28, 2007 hearing there would appear to be sufficient basis to conclude that Dorozhko's hack violated the Computer Fraud and Abuse Act, the mail fraud statute, and the wire fraud statute. The U.S. Attorney's Office has authority to seize Dorozhko's trading proceeds under 18 U.S.C. § 981(b).

However, since the SEC has apparently declined, for whatever reason, to involve the criminal authorities in this case, we must address an inconvenient truth about our securities laws—an issue that has sent Supreme Court justices into dissent and provoked numerous law review articles.

98. The Court stated:

Upon a searching review of existing case law, and for the reasons that follow, we believe that we are constrained to hold that Dorozhko's alleged "stealing and trading" or "hacking and trading" does not amount to a violation of § 10(b) and Rule 10b-5 because Dorozhko did not breach any fiduciary or similar duty "in connection with" the purchase or sale of a security. Although Dorozhko may have broken the law, he is not liable in a civil action under § 10(b) because he owed no fiduciary or similar duty either to the source of his information or to those he transacted with in the market. As the Supreme Court famously
On appeal, the Second Circuit reversed the district court’s denial of the SEC’s request for a preliminary injunction. Although the Second Circuit agreed that the hacker was not under a fiduciary duty that would trigger the disclose or abstain rule, it held that liability could be found even in the absence of a fiduciary duty. The hacker could be held accountable for the trades under Rule 10b-5 to the extent he had acquired the nonpublic information through a misrepresentation. The Second Circuit remanded the case to the district court for determination of whether the hacker obtained the information in a deceptive manner through a misrepresentation, which would include a misrepresentation of the hacker’s identity.

There is sparse authority on whether a theft of information is sufficient to trigger Rule 10b-5’s disclose or abstain obligation. Thus, held in Chiarella, and has reaffirmed since, “one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so


99. Dorozhko, 574 F.3d at 50–51.

100. Id.

101. Id. at 50 (“[W]e adopt the SEC’s proposed interpretation of Chiarella and its progeny: ‘misrepresentations are fraudulent, but ... silence is fraudulent only if there is a duty to disclose.’” (second alteration in original) (quoting Opening Brief of the Securities & Exchange Commission, Appellant at 44, Dorozhko, 574 F.3d 42 (No. 08-0201-cv))). The Second Circuit in Dorozhko, id. at 49, also pointed to Basic Inc. v. Levinson as “distinguishing ‘situations where insiders have traded in abrogation of their duty to disclose or abstain,’ from ‘affirmative misrepresentations by those under no duty to disclose (but under the ever-present duty not to mislead).’” (quoting 485 U.S. 224, 240 n.18 (1988)).

102. The Court explained:

In our view, misrepresenting one’s identity in order to gain access to information that is otherwise off limits, and then stealing that information is plainly “deceptive” within the ordinary meaning of the word. It is unclear, however, that exploiting a weakness in an electronic code to gain unauthorized access is “deceptive,” rather than being mere theft. Accordingly, depending on how the hacker gained access, it seems to us entirely possible that computer hacking could be, by definition, a “deceptive device or contrivance” that is prohibited by Section 10(b) and Rule 10b-5.

However, we are hesitant to move from this general principle to a particular application without the benefit of the District Court’s views as to whether the computer hacking in this case—as opposed to computer hacking in general—was “deceptive.”

Id. at 51: see also Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372, 389 (5th Cir. 2007) (“[T]he [Supreme] Court ... has established that a device, such as a scheme, is not ‘deceptive’ unless it involves breach of some duty of candid disclosure.” (citing Chiarella, 445 U.S. at 234–35; O’Hagan, 521 U.S. at 655)).

103. Dorozhko, 606 F. Supp. 2d 321 (reversed by the Second Circuit) appears to be the only ruling on point and even there the court gave the SEC an opportunity to replead its claim. Cf. United States v. Bryan, 58 F.3d 933 (4th Cir. 1995) (in a case decided before the Supreme Court’s O’Hagan decision, the Fourth Circuit ruled against a claim that stolen information could form the basis of a Rule 10b-5 duty but the court based its decision on a rejection of the misappropriation theory that was since adopted in O’Hagan). The court in Dorozhko also noted that the Seventh Circuit in SEC v. Cherif, 933 F.2d 403, 411 (7th Cir. 1991), did not reach the issue of whether a theft was sufficient since the thief
this is far from a settled question. At least one case presented the issue squarely, but was settled before adjudication on the merits. In that case, the SEC filed charges under Rule 10b-5 against someone who snuck into his brother-in-law's bedroom, hacked his computer files, and traded on the material nonpublic information he thereby acquired. The parties reached a settlement that included disgorgement and a fine. Until definitively decided by more courts, there remains a plausible argument that someone who steals inside information in order to trade to his or her advantage may be held accountable under Rule 10b-5. As noted above, this most certainly would be the case if the theft was enabled by a misrepresentation. But drawing a distinction between deceptive and non-deceptive theft is not easy—and as a matter of sound

was a former employee who breached a duty imposed by the employment relationship. See Dorozhko, 606 F. Supp. 2d at 339-40.

104. See SEC v. Stummer, Litigation Release No. 20529, 93 SEC Docket 115 (Apr. 17, 2008). The defendant entered into a consent decree and agreed to pay $46,386.66, "representing the disgorgement of his illegal trading profits, prejudgment interest, and a civil penalty in an amount equal to the profits." Id.

105. Id.

106. Id.

107. As the district court in Dorozhko, acknowledged, two leading authorities support the view that stolen information can form the basis of Rule 10b-5's obligation not to trade on material nonpublic information. See 606 F. Supp. 2d at 341 (citing 18 Langevoort, supra note 9, § 6:14; Robert A. Prentice, The Internet and Its Challenges for the Future of Insider Trading Regulation, 12 Harv. J.L. & Tech. 263, 296-307 (1999)); see also SEC v. Rocklage, 470 F.3d 1 (1st Cir. 2006) (although there was no basis for a traditional fiduciary duty, a spouse's alleged acquisition of insider information from her husband so that she could alert her brother was deceptive and occurred in connection with the brother's sale of his securities); Robert Steinbuch, Mere Thieves, 67 Md. L. Rev. 570, 608 (2008) ("[G]iven courts' expansion of the misappropriation theory from a narrow version in O'Hagan to the endorsement of the broader liability in Rule 10b-5, Rocklage's removal of the fiduciary requirement, and the reinvigoration of the version of the misappropriation theory originally outlined in the Chiarella dissent, one is left with the inescapable conclusion that mere thieves are liable for insider trading under Rule 10b-5."). C.f. Langevoort, supra note 40, at 1298 ("[The] principal drafters [of the Insider Trading Sanctions Act] regarded those who trade on material confidential information as 'thieves,' deserving substantial penalties."). But see Kathleen Coles, The Dilemma of the Remote Tippee, 41 Gonz. L. Rev. 181, 221 (2005) ("The burglar and computer hacker may be liable for the conversion of nonpublic information under other laws, but the insider trading laws themselves appear not to prohibit the burglar or hacker from trading or tipping on the basis of the stolen information. This is because there was no breach of a duty of loyalty to traders under the classic theory or to the source of the information under the misappropriation theory."). quoted in Dorozhko, 606 F. Supp. 2d at 341-42.

108. See supra notes 99-102 and accompanying text.


[A] thief who steals a lawyer's wallet, uses his card key to gain access to the law firm's premises, sees information on an open computer, and then trades on that information, has arguably misrepresented his identity to gain access and is liable for securities fraud, even though no person has been defrauded. But what if the thief is legitimately on the law firm's premises delivering lunch to a conference room and, while on the premises, picks the lock on an office to obtain confidential information? Is that "deceiving the lock" (fraud), or is it exploiting a security weakness (theft)?
jurisprudence, the utility and rationality of making outsider trading liability turn on such a distinction is open to question.

The *Dorozhko* court’s rationale leads to uneven results in two fact situations involving wrongdoing that have the same impact on the securities markets. Consider the impact of *Dorozhko* in the following situations. A thief who misrepresents his identity so that he can obtain nonpublic information in order to trade securities on the basis of knowledge that is superior to that of other market participants violates Rule 10b-5. However, an ordinary thief is treated differently. Thus, for example, the thief who breaks and enters will not violate Rule 10b-5, but the thief who uses false identification to obtain entry and then trades on the information has violated the securities laws. This seems a bit anomalous since both thieves’ conduct have the same deceptive impact on the securities markets, and Rule 10b-5(c) prohibits conduct that operates as a fraud or deceit.\(^\text{110}\) Unfortunately, this anomalous result is not uncommon to Rule 10b-5 and insider trading. For example, as noted earlier, Rule 10b-5 was violated when a psychiatrist took advantage of confidential information obtained from a patient,\(^\text{111}\) but not by a stockbroker who traded on nonpublic information provided by a customer who himself wanted to take advantage of the nonpublic information.\(^\text{112}\)

As noted above, Rule 10b-5(c) prohibits conduct that *operates* as a fraud or deceit. This means that courts need to look to the functional impact of the conduct.\(^\text{113}\) Therefore, if an outsider wrongfully obtains information with the scienter or intent to trade required by section 10(b), this should be covered by Rule 10b-5. The requisite statutory deception could be found in the investors’ reliance on the integrity of the market, in the same way that the Supreme Court allowed a fraud-on-the-market approach to establish a presumption of reliance.\(^\text{114}\) The weakness in this argument is that it comes close to the fact pattern in *Chiarella*, which held that something more than knowing use of nonpublic information is required to violate Rule 10b-5.\(^\text{115}\) However, the argument that a Rule 10b-5 violation can be premised on the knowing use of *wrongfully*

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\(^{110}\) See 17 C.F.R. § 240.10b-5(c) (2009).


\(^{114}\) See *Basic Inc. v. Levinson*, 485 U.S. 224, 225 (1988) (permitting a presumption of reliance based on the efficient capital market hypothesis, which posits that investors should be able to rely on the market price as a fair reflection of publicly available information). For discussion of fraud on the market, see 4 *HAZEN*, supra note 2, § 12.10(6).

obtained nonpublic information was not made in the Chiarella case. In Chiarella, a printer's employee traded on information obtained in a not-yet-public tender offer filing being printed by the defendant's employer.\textsuperscript{116} The Court's opinion noted that had a breach of duty been alleged based on the defendant's employment relationship, a violation might have been shown.\textsuperscript{117} Several years later, in United States v. O'Hagan, the Supreme Court made it clear that the employment relationship would suffice.\textsuperscript{118} The issue discussed herein is another question left unanswered by the Chiarella decision—what type of wrongdoing is sufficient to trigger the disclose or abstain obligation. As is clear from the discussion that follows, Rule 10b-5 liability is not limited to breaches of a fiduciary duty.\textsuperscript{119}

\section*{B. \textit{SEC v. Cuban}}

Many of the cases involving the misappropriation theory are based on a fiduciary or fiduciary-like relationship.\textsuperscript{120} But the misappropriation theory can also be applied in the absence of a fiduciary relationship when the information has been supplied under a confidentiality agreement, at least where the agreement prohibits both disclosure and use of the information.\textsuperscript{121} There is conflicting authority as to whether the existence

\begin{footnotes}
\item[116] Id. at 224.
\item[117] Id. at 235–36.
\item[118] 521 U.S. 642, 652–53 (1997). The defendant in O'Hagan was an attorney who learned of nonpublic information emanating from a firm's client. Id. at 647–48. O'Hagan was not working on the case and thus was not directly bound by the attorney-client privilege to keep the information confidential. See id. at 647. On the other hand, the Court found sufficient deception based on O'Hagan's trading on the information and thereby deceiving the law firm from which the information came. Id. at 666.
\item[119] Professor Nagy suggests that additional SEC rulemaking is necessary to include other wrongdoing as a basis for insider or outsider trading liability. See Nagy, supra note 32, at 1379. ("[W]hile this view can be justified by the policy objectives underlying the Supreme Court's decisions, it currently lacks a solid doctrinal foundation."). Professor Nagy recommends that the Supreme Court adopt an interpretation and the SEC engage in rulemaking that focuses on the impact on investors under a "fraud on investors" theory. Id. at 1374–78. My view is that, although it would be helpful for the Supreme Court to adopt a broader theory of section 10(b), it is both unlikely and unnecessary since Rule 10b-5(c) and existing case law support such an interpretation with respect to: (1) confidentiality agreements, (2) circumstances giving rise to a reasonable expectation of confidentiality, and (3) certain close family relationships. See infra notes 129–30 and accompanying text. Professor Nagy and I agree, however, that the current murky state of the case law could be remedied by congressional action. See infra notes 164–71 and accompanying text. Congress is currently considering a number of regulatory reforms in the wake of the financial crisis of 2008–2009. This presents a good opportunity to revisit insider trading as well. As pointed out below, even with expansive interpretation of existing law, the law of insider and outsider trading likely will remain muddled unless Congress acts by adopting a statutory definition setting forth a brighter line of when trading prohibitions come into play.
\item[120] See, \textit{e.g.}, O'Hagan, 521 U.S. at 653 (attorney in law firm clothed with attorney-client obligations); SEC v. Willis, 825 F. Supp. at 618 (psychiatrist/patient relationship).
\item[121] SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009).
\end{footnotes}
of a confidentiality agreement is enough, in and of itself, to create a fiduciary relationship between the contracting parties. 122 The discussion that follows focuses on identifying a fiduciary or fiduciary-like relationship sufficient to trigger the disclose or abstain rule as well as what types of confidentiality agreements will be sufficient.

In SEC v. Cuban, the SEC brought insider trading charges based on a breach of a confidentiality agreement regarding a company's plan to engage in a private investment in public equity (PIPE) offering. 123 An amicus brief filed by a number of law professors unsuccessfully urged that Rule 10b5-2 is overly broad. 124 They argued that the enabling statute—section 10(b)—only authorizes the SEC to promulgate liability rules based on fraudulent conduct, which in turn requires—under the misappropriation theory announced by the Supreme Court in O'Hagan—the breach of a fiduciary or functionally equivalent duty, as opposed to a merely contractual one. 125 The amici reasoned that if Rule 10b5-2 were construed to extend section 10(b) liability to situations involving the mere breach of a confidentiality agreement, the rule would create liability for trading on nonpublic information in the absence of a statutorily sufficient fraud. 126 This would go beyond the regulatory authority granted to the SEC and would render the rule invalid as overly broad. The amicus brief's essential argument was that when a defendant trades on the basis of nonpublic information obtained pursuant to a confidentiality agreement, he does not commit fraud within the meaning of section 10(b), since he is not a fiduciary of the source of the information and thus has no duty to disclose or abstain from trading. 127

122. See Goscicki v. Custom Brass & Copper Specialties, Inc., 229 F. Supp. 2d 743, 757 (E.D. Mich. 2002) ("[Fiduciary] relationships may be found to exist either by virtue of an express confidentiality non-use/non-disclosure agreement or, in appropriate circumstances, may be implied by law."); Larsen v. Consol. Pet Foods, Inc., 144 B.R. 121, 162 (Bankr. D. Colo. 1992) (finding confidentiality agreement between parties created a fiduciary relationship as a matter of law). But see Barrett v. Freifeld, 64 A.D.3d 736, 739 (N.Y. App. Div. 2009) ("The creation of a fiduciary duty does not depend upon the existence of an agreement or contract between the parties, but results from the relationship between the fiduciary and the beneficiary."); MobiApps, Inc. v. Quake Global, Inc., No. 06cv1745-LAB (JMA), 2007 U.S. Dist. LEXIS 34681, at *22 n.3 (S.D. Cal. May 9, 2007) ("The existence of confidentiality agreements supports an inference that no fiduciary relationship was established or intended.").


124. Brief of Amici Curiae in Support of Defendant's Motion to Dismiss, Cuban, 634 F. Supp. 2d 713 (No. 3:08-cv-02050) (arguing for the invalidity of Rule 10b5-2 on the grounds that a breach of a confidentiality agreement is not sufficient to support liability under section 10(b) since liability under that section requires a breach of a fiduciary or similar duty).

125. See id. at 2; SEC's Case Against Cuban Looks Set for Long Fight as Academics Join Fray, [Jan.-June] 41 Sec. Reg. & L. Rep. (BNA) No. 8, at 295 (Feb. 23, 2009); see also Nagy, supra note 32, at 1317 (written prior to the most recent Doroczko and Cuban decisions and positing that a fiduciary duty is required by the controlling Supreme Court cases).

126. See Brief of Amici Curiae in Support of Defendant's Motion to Dismiss, supra note 124.

127. Id.
the absence of a duty to disclose or refrain, he cannot be held liable for outsider trading under section 10(b).

Contrary to the position urged by the law professors' amicus brief, the better view, and the one accepted by the federal district court in Cuban, is that a breach of contractual obligation can be sufficient to ground a section 10(b) violation. The applicable statutory language of section 10(b) plainly creates broad liability for "deceptive" conduct—nowhere does it limit the SEC's rulemaking authority to prohibitions on trading conduct involving breaches of fiduciary duty. Promising to uphold a confidence and then breaching the duty so created can properly be characterized as "deceptive." It follows that Rule 10b-5 is not beyond the SEC's rulemaking authority and, accordingly, breach of a contractual confidentiality agreement should be able to form the basis of a Rule 10b-5 outsider trading violation.

Notwithstanding the SEC's arguments to the contrary, the district court dismissed the insider trading claim against Mr. Cuban. The court, however, gave the SEC leave to file an amended complaint. Although

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Nothern contends, to the contrary, that a confidentiality agreement between Davis and Treasury is insufficient to create a relationship underlying any § 10(b) liability. In support of that contention, Nothern cites United States v. Kim, which held that an express "Confidentiality Commitment" between members of a social club for business executives did not give rise to any legal duty because it failed to set forth "a relationship with the hallmarks of a fiduciary relationship." That case is inapposite for two reasons.

First, as the court itself noted in Kim, the language of Confidentiality Commitment "appealed only to the members' ethics and morality" and did not create a legal duty to refrain from disclosing confidential information. Here, the facts alleged by the SEC, if true, indicate that the agreement between Davis and Anderson created a contractual duty not to disclose embargoed Treasury information.

Second, Kim relies on the opinion of the Court of Appeals for the Second Circuit in United States v. Chestman, which, in turn, held that a "similar relationship of trust and confidence" must be the "functional equivalent of a fiduciary relationship," meaning that it must be characterized by superiority or dominance. Kim, 184 F. Supp. 2d at 1011–11 (citing Chestman, 947 F.2d at 568). The Second Circuit later clarified that holding, without reference to the existence of superiority or dominance ....

Id. (citations omitted) (quoting United States v. Kim, 184 F. Supp. 2d 1006, 1011 (N.D. Cal. 2002)); see also, e.g., United States v. Falcone, 257 F.3d 226, 234–35 (2d Cir. 2001) ("[A] fiduciary relationship, or its functional equivalent, exists only where there is explicit acceptance of a duty of confidentiality or where such acceptance may be implied from a similar relationship of trust and confidence between the parties. Qualifying relationships are marked by the fact that the party in whom confidence is reposed has entered into a relationship in which he or she acts to serve the interests of the party entrusting him or her with such information."); SEC v. Lyon, 605 F. Supp. 2d 531 (S.D.N.Y. 2009) (upholding SEC complaint against insiders who made short sales prior to public announcement of pending PIPE offering).

131. See Cuban, 634 F. Supp. 2d at 731.
132. See id. The SEC let the court enter judgment without filing an amended complaint, thus
it dismissed the initial complaint, the court's ruling in Cuban rejected a number of the defendant's attempts to narrow Rule 10b-5 liability for outsider trading. The court nevertheless accepted the questionable defense that a confidentiality agreement, as opposed to a nonuse agreement, cannot be sufficient by itself to invoke the disclose or abstain rule with respect to securities trading.

The district court in Cuban quite properly rejected the defendant's contention that the existence of a fiduciary duty was to be determined exclusively as a matter of state law. The court also properly rejected the defendant's argument that the disclose or abstain rule applies only if there is a fiduciary or fiduciary-like duty. The court thus acknowledged that a nonuse agreement would be sufficient to trigger the disclose or abstain rule, even if the parties did not stand in a fiduciary relationship. However, the district court held that an agreement to keep information confidential is not sufficient to trigger the disclose or abstain rule unless the agreement prohibits trading on the information in question. This


133. 634 F. Supp. 2d at 724-25.
134. Id. at 730-31.
135. Id. at 721-22. The court thus refused to agree with plaintiff's reliance on Southwest Realty, Ltd. v. Daseke, No. CA3-89-3055-D, 1992 WL 373166, at *9-10 (N.D. Tex. May 21, 1992), for the proposition that state law was the proper measure of fiduciary obligations in insider trading cases. See Cuban, 634 F. Supp. 2d at 721-22. The court stated:

Moreover, although the source of a duty adequate to support insider trading liability can be found in state law—this certainly appears to be the case, for example, in O'Hagan—it may be located elsewhere without violating the general rule against creating federal common law. The SEC can promulgate a rule that imposes such a duty, provided the rule conforms with the SEC's rulemaking powers, such as those found in § 10(b) of the Exchange Act. In doing so, the SEC does not create federal general common law. Id. at 722 (citation omitted).

137. Id.
138. Id. ("The agreement, however, must consist of more than an express or implied promise merely to keep information confidential. It must also impose on the party who receives the information the legal duty to refrain from trading on or otherwise using the information for personal gain."). The court similarly rejected the SEC's reliance on Rule 10b5-2(1)(a):

Because Rule 10b5-2(b)(1) attempts to predicate misappropriation theory liability on a mere confidentiality agreement lacking a non-use component, the SEC cannot rely on it to establish Cuban's liability under the misappropriation theory. To permit liability based on Rule 10b5-2(b)(1) would exceed the SEC's § 10(b) authority to proscribe conduct that is deceptive. This is because, as the court has explained, under the misappropriation theory of liability, it is the undisclosed use of confidential information for personal benefit, in breach of a duty not to do so, that constitutes the deception.

Id. at 730-31 (citation omitted) (citing United States v. O'Hagan, 521 U.S. 642, 651 (1997) ("Liability
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conclusion was based on the rationale that "[w]ith respect to confidential information, nondisclosure and non-use are logically distinct." This conclusion is highly questionable, especially in the context of trading in securities. The court could easily have avoided the distinction it drew between confidentiality and nonuse agreements by implying nonuse from confidentiality as a legal presumption.

Even if it is assumed there is a meaningful distinction between confidentiality and nonuse agreements for trading purposes, it would seem natural to imply nonuse from an agreement to keep information confidential. The court itself acknowledged that a complaint alleging an implied nonuse agreement could be sufficient. Thus, even without a presumed implication of nonuse from a confidentiality agreement, a nonuse agreement could still be implied under appropriate circumstances. Given Mr. Cuban's status as a large shareholder of the company requiring the confidentiality agreement, it would be reasonable to permit the fact finder to imply a nonuse agreement without requiring the SEC to file an amended complaint.

Under classical insider trading, a company insider clearly could not do what Mr. Cuban did and trade to his or her advantage based on nonpublic information about a company's pending PIPE offering. According to the evidence, even Mr. Cuban recognized that he was likely in a position where he could not trade. The courts have long recognized

under Rule 10b-5, our precedent indicates, does not extend beyond conduct encompassed by § 10(b)'s prohibition.

139. Id. at 723. Pointing to O'Hagan, the court reasoned:
A person who receives material, nonpublic information may in fact preserve the confidentiality of that information while simultaneously using it for his own gain. Indeed, the nature of insider trading is such that one who trades on material, nonpublic information refrains from disclosing that information to the other party to the securities transaction. To do so would compromise his advantageous position.

Id. at 725 (citing O'Hagan, 521 U.S. at 656).

140. The facts of the Cuban case present a particularly good case for implying a nonuse agreement since the defendant's position as a major shareholder meant that he had a preexisting special relationship with the company. See id. at 717, 720.

141. Id. at 724-25.

142. Cf. Jonathan R. Macey, From Fairness to Contract: The New Direction of the Rules Against Insider Trading, 13 Hofstra L. Rev. 9, 63 (1984) ("[T]he legitimate policy concerns about insider trading are really concerns about the proper allocation of property rights in valuable information. The Supreme Court's recent opinions in Dirks and Chiarella, by focusing on the fiduciary duty owed by traders to the owners of insider information, employ a method of analysis consistent with this hypothesis.").

143. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), and its progeny make it clear that a company insider is under a disclose or abstain obligation. The premise of classical insider trading has been accepted in all of the Supreme Court's insider trading decisions. See, e.g., O'Hagan, 521 U.S. at 651-52 (citing Chiarella v. United States, 445 U.S. 222, 228-29 (1980); Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983)).

144. Cuban, 634 F. Supp.2d at 717. ("At the end of the call Cuban said: 'Well, now I'm screwed. I can't sell.' "). There was evidence to support the company's expectation that Mr. Cuban would not use
the concept of a “temporary insider”\textsuperscript{145} with respect to someone who has access to nonpublic information because of his or her relationship with the company.\textsuperscript{146} This could have been applied to Mr. Cuban’s situation.

Rule 10b-5 tippee liability would also have resulted if a company insider had passed on the information to an outsider in order to allow the

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the information given under the confidentiality agreement:

Two internal company emails quoted in the complaint indicate that the executive chairman of Mamma.com may have expected that Cuban would not sell his shares until after the PIPE was announced. [Cuban] said he would sell his shares (recognizing that he was not able to do anything until we announce the equity)[,.] . . . [Cuban’s] answers were: he would not invest, he does not want the company to make acquisitions, he will sell his shares which he can not [sic] do until after we announce.”).

\textit{Id.} (second, third, fifth, and sixth alterations in original) (citations omitted) (quoting Complaint ¶¶ 15, 20, Cuban, 564 F. Supp. 2d 713 (No. 3:08-CV-2050-D))


146. A number of leading commentators have acknowledged temporary insider status. \textit{See}, e.g., 3C Harold S. Bloomental \& Samuel Wolff, \textit{Securities and Federal Corporate Law} § 19:53 (2009) (“The [Report of House Committee on Energy and Commerce] also made it clear that under its conception of the substantive law, in addition to conventional insiders, so-called ‘temporary insiders’ (that is, persons such as lawyers and investment bankers to whom insiders have conferred nonpublic information with the expectation that it remain confidential) have a duty not to trade on the basis of inside information.”); 3 Alan R. Bromberg \& Lewis D. Lowenfelds. Bromberg \& Lowenfelds ON \textit{Securities Fraud and Commodities Fraud} § 6:307 (2009) (acknowledging temporary insider as basis for insider trading liability); 18 Langevoort, \textit{supra} note 9, § 3.8 (same); 1 Wang \& Steinberg, \textit{supra} note 9, § 5:2.3(D) (discussing “temporary insiders who are neither employees nor independent contractors”); Jonathan Macey, \textit{Getting the Word out About Fraud: A Theoretical Analysis of Whistleblowing and Insider Trading}, 105 Mich. L. Rev. 1899, 1922 (2007) (“The rules against insider trading are meant to protect public companies and investors from theft of information that properly belongs to them. Insiders such as executives or directors, and ‘temporary insiders’ such as attorneys, accountants, financial printers, and investment bankers routinely obtain confidential information about a company in the course of their work. The insider trading rules are intended to prevent both these permanent and temporary insiders from abusing their positions of trust by trading in violation of their legal duties of confidentiality.”); D. Gordon Smith, \textit{The Critical Resource Theory of Fiduciary Duty}, 55 Vand. L. Rev. 1399, 1420 (2002) (referring to temporary insiders’ accountability under Rule 10b-5).
outsider to profit from trading on the information.\textsuperscript{147} It would have been completely consistent with Rule 10b-5 precedent to have found an implied nonuse agreement flowing directly from the express nondisclosure agreement. To do otherwise, as the Cuban court did, can be seen as turning the tipper/tippee cases on their heads.\textsuperscript{148} For example, if the court's distinction between a nondisclosure and a nonuse agreement prevails in other cases, companies entering into confidentiality agreements that do not include nonuse could be seen as knowingly sanctioning trading on nonpublic information. If a company agrees to a confidentiality agreement that is found to fall short of a nonuse agreement, the result would be to enable trading on the nonpublic information. This would be an unfortunate result that would enable trading when it should be prohibited, as it would under an analogy to tipper/tippee liability.\textsuperscript{149} A company passing on sensitive information with a confidentiality agreement not including a nonuse agreement thus could be seen as acting with reckless disregard as to

\textsuperscript{147. See Dirks v. SEC, 463 U.S. 646, 659–60 (1983). Tippee liability is discussed in 4 Hazen, supra note 2, § 12.17(5).}

\textsuperscript{148. In fact, the Court in Dirks acknowledged the concept of a temporary insider:

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

\textsuperscript{463 U.S. at 655 n.14, quoted in 2 Brent A. Olson, Regulation of Securities Transactions Among Officers, Directors, and Shareholders § 17:46 (2009); see also 4 Bromberg & Lowenfels, supra note 146, § 6:476.}

The murky part of note 14 is this. Does the "special confidential relationship" connote anything more than working for or with the corporation and receiving confidential information for that purpose and with expectation (at least by the corporation) that the information will be kept confidential? Analytically, no more should be necessary. "Special confidential relationship" is probably only a legal conclusion describing the relationship, not a phrase that must be used—or a concept that must be held—by the parties when they create the relationship.

The company's expectation that information be kept confidential can be evidenced in several ways. One is by marking the information "confidential" or otherwise so identifying it. Another is by confidentiality agreements, ranging from informal oral understandings to formal written documents (e.g., the kind often used in supplying information to proposed acquisition partners and their advisers).

The Dirks Court's additional requirement—that the temporary insider's relationship to the company must imply a duty to keep the information confidential—is puzzling. It seems superfluous when there is an express agreement or warning to keep the information confidential.

\textsuperscript{Id.}

\textsuperscript{149. See 4 Hazen, supra note 2, § 12.17(5).}
whether the recipient of the information planned to trade on it to his or her advantage. Such reckless disregard could rise to the level of scienter sufficient to sustain Rule 10b-5 liability. This possibility alone would seem sufficient reason to infer a nonuse agreement from the presence of a confidentiality agreement.

The nondisclosure/nonuse distinction drawn in the Cuban decision means that companies must take care when drafting confidentiality agreements lest the agreement be construed as permitting trading on nonpublic information provided pursuant to the agreement. A related problem is the impact of a confidentiality agreement on Regulation Fair Disclosure’s (“Regulation FD”) ban on selective disclosure of information by publicly traded companies. Among other things, Regulation FD permits the selective disclosure of material, nonpublic information “to a person who expressly agrees to maintain the disclosed information in confidence.” Regulation FD does not expressly require a nonuse agreement prohibiting trading on the disclosed information. Although not mentioning Regulation FD, the court’s reasoning in Cuban suggests that a confidentiality agreement to permit selective disclosure under Regulation FD should include a prohibition on trading. With respect to agreements drafted prior to the Cuban decision, it is to be hoped that the courts would imply nonuse from a confidentiality agreement. To do otherwise would seriously undermine the purpose of Regulation FD, especially since that regulation was adopted amid concerns about impermissible trading on nonpublic inside information.

The foregoing discussion points out that the court’s opinion in SEC v. Cuban took a much too narrow view of the misappropriation theory.

150. Reckless conduct is sufficient to support a finding of scienter. Cf. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 319 n.3 (2007) (not deciding the issue but noting that “[e]very Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement by showing that the defendant acted intentionally or recklessly, though the Circuits differ on the degree of recklessness required”). Scienter can be inferred from circumstantial evidence. Cf. id. at 328. (“A plaintiff alleging fraud in a § 10(b) action, we hold today, must plead facts rendering an inference of scienter at least as likely as any plausible opposing inference.”).


152. 17 C.F.R. § 243.100(b)(2)(ii).


154. Cf. Macey, supra note 146, at 1922 (“The rules against insider trading are meant to protect public companies and investors from theft of information that properly belongs to them. Insiders such as executives or directors, and ‘temporary insiders’ such as attorneys, accountants, financial printers, and investment bankers routinely obtain confidential information about a company in the course of their work. The insider trading rules are intended to prevent both these permanent and temporary insiders from abusing their positions of trust by trading in violation of their legal duties of confidentiality.”).
The court acknowledged that a nonuse agreement could be implied. In the court's words, there must be "an express or implied agreement... not to disclose material, nonpublic information... and not to trade on or otherwise use the information." It seems likely that a complaint alleging this implication more specifically would have been accepted by the court as sufficient. Since the information was supplied to Mr. Cuban in furtherance of a corporate purpose, he should have been considered a temporary insider—especially when viewed in conjunction with the confidentiality agreement which should have been interpreted to include a nonuse agreement. It seems reasonable to presume or infer nonuse from a confidentiality agreement in much the same way that courts have presumed use of nonpublic information from

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156. Id. at 727.
158. See, e.g., David M. Brodsky & Daniel J. Kramer, A Critique of the Misappropriation Theory of Insider Trading, 20 CADOZO L. REV. 41, 57 (1998) ("[L]awyers, accountants, bankers, and others who have a limited but special, confidential relationship with a corporation that gives them access to information intended only for corporate purposes may be 'temporary insiders' who have a duty not to trade in the corporation’s securities until the confidential information has been disclosed."); Elliott J. Weiss, United States v. O’Hagan: Pragmatism Returns to the Law of Insider Trading, 23 J. CORP. L. 395, 396 (1998) (acknowledging temporary insider status as a basis for insider trading liability). But see Seligman, supra note 145, at 1132 (1985) (questioning whether the Lund decision would have survived Supreme Court scrutiny).
trading while in possession of the information. Such a presumption is consistent with the remedial purpose of section 10(b) and Rule 10b-5 that has been noted in other recent insider trading cases and by the Supreme Court. It remains to be seen whether other courts will accept the unusually narrow reading of Rule 10b-5 in Cuban.

As noted above, it is clear that a nonuse agreement even without a traditional fiduciary duty can form the basis of Rule 10b-5 liability. The fiduciary nature of a relationship, and an agreement that expressly or impliedly requires nonuse of information, both support the misappropriation theory in precluding someone from trading while in possession of material nonpublic information.

In addition, the Second Circuit's decision in SEC v. Dorozhko, under which outsider trading liability can be based on a misrepresentation rather than a per se expectation of confidentiality, provides an alternative basis for upholding an insider trading claim in the face of a confidentiality agreement. For example, in the Cuban case, Mr. Cuban's confidentiality agreement could be viewed as a misrepresentation that induced the company to provide him with the information about the upcoming offering that in turn enabled him to trade on the information so provided.

IV. CONGRESSIONAL ACTION IS WARRANTED

Although reasonable people may differ on the foregoing conclusions, they are amply justified under the current statute. Under current law, the extension of insider trading prohibitions to outsiders presents difficult and nuanced issues because of the need to link trading prohibitions to a statute framed in terms of curbing deception. Much
trading on nonpublic information can be fit within the deception framework. However, this leads to the uneven results discussed above.\footnote{164} The law of insider trading and outsider trading has been made unnecessarily complex by the absence of a clear statutory definition of when trading on material nonpublic information is a securities law violation. Congress should resume the task it started and then abandoned in 1984 of defining appropriate trading prohibitions.\footnote{165} Congress should consider reviving the rule followed by many courts, prior to the \textit{Chiarella} decision, that precluded trading on the basis of nonpublic confidential information without tying the obligation to a fraud-based rule.\footnote{166} This approach gained traction abroad\footnote{167} and deserves attention here. A rule premised on unfair, unequal access to information\footnote{168} is a more direct and thus preferable approach to the machinations forced by the current statute.\footnote{169} The proposed rule focuses on the problem of unequal access and resulting unfairness\footnote{170} that is in reality the reason to prohibit trading on nonpublic information.\footnote{171} Without a statutory clarification the courts are left to fashion the common law of Rule 10b-5 as best they can within the parameters of section 10(b). However, as hard as they may try, the limitations of the

\begin{itemize}
\item \textit{[The obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications.]} \footnote{169. As explained in the \textit{Texas Gulf Sulphur} case, "Rule [10b-5] is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information." 401 F.2d 833, 848 (2d Cir. 1968) (citing William Cary, \textit{Insider Trading in Stocks}, 21 BUS. LAW. 1009, 1010 (1966)).}
\item \textit{The Securities Exchange Act "purposed to prevent inequitable and unfair practices and to insure fairness in securities transactions generally, whether conducted face-to-face, over the counter, or on exchanges." Id. (citing 3 \textit{LOUIS LOSS, SECURITIES REGULATION} 1455-56 (2d ed. 1961)).}
\item \textit{Outsider trading activity is detrimental to the integrity of the national securities markets."}; \textit{Strickler, supra note 11, at 523 ("Outsider trading activity is detrimental to the integrity of the national securities markets."); Langevoort, \textit{Insider Trading, supra note 9, at 50-51 (urging a broad application of the misappropriation theory and recognizing equal access to information as a valid goal of the securities laws).}}
\end{itemize}
current statute do not leave room for a coherent approach to insider and outsider trading.

CONCLUSION

Despite its development in the courts for more than forty years, the federal law of insider and outsider trading remains in an unacceptable state of flux. This Article has examined recent developments in the law of outsider trading. The recent cases have been overly restrictive in three respects.

First, although the district court in Cuban got it right in part, the court still put too heavy a burden on the government in cases seeking to establish outsider trading prohibitions. The court was correct in rejecting the defense's claim, supported by a number of law professors, that Rule 10b-5(c)'s disclose or abstain obligation for those in possession of material nonpublic information is limited to breaches of fiduciary duty. However, as pointed out above, the court erred in refusing to uphold the SEC's complaint alleging that the trading was actionable as a breach of the confidentiality agreement. The court's confidentiality/nonuse distinction is spurious. Even accepting the distinction, the court should have allowed the complaint to go forward on the ground that the nonuse agreement could be inferred from a confidentiality agreement instead of requiring an amended pleading to make that explicit.

Second, the Supreme Court in Chiarella taught us that although knowing possession and use of nonpublic information is not sufficient to violate Rule 10b-5, a violation can be premised on a breach of duty or other wrongdoing. Contrary to the Second Circuit's ruling in Dorozhko, there is a plausible argument that a theft is sufficient wrongdoing to support a Rule 10b-5 violation. The Dorozhko court was correct, however, in reversing the district court's denial of the SEC's request for a preliminary injunction, reasoning that a claim could be made if the thief obtained the information by means of a misrepresentation.

Third, the Chiarella decision signaled the possibility of a broad reading of the type of wrongdoing sufficient to support a Rule 10b-5 trading violation. Rule 10b5-2 is based on this interpretation. Contrary to the implication of some of the cases, SEC Rule 10b5-2 is well within the reach of Rule 10b-5 and the Court's lessons from Chiarella.

This Article makes a final recommendation. The need to link outsider trading to the statutory deception requirement has made it unnecessarily difficult to fashion a rational approach. Federal securities

172. See, e.g., SEC v. Yun, 327 F.3d 1263, 1273 n.23 (11th Cir. 2003) ("[T]he SEC's new rule goes farther than we do in finding a relationship of trust and confidence (e.g., the new rule creates a presumption of a relationship of trust and confidentiality in the case of close family members) . . . ."); SEC v. Cuban, 634 F. Supp. 2d 713, 730-31 (N.D. Tex. 2009); United States v. Kim, 184 F. Supp. 2d 1006, 1014-16 (N.D. Cal. 2002).
law is statutory in nature and is not well suited to the common law development of insider and outsider trading rules. Congress should return to the task it started and then abandoned in 1984 of defining appropriate trading prohibitions such as those fashioned in the pre-
Chiarella case law.

Congressional action is the preferred solution. Given the history in this regard, there is a possibility that legislation is not in the offing. This Article has pointed out that even in the absence of Congressional action, the recent cases have taken too narrow a view of outsider trading under existing law.