

NOTE

SEC RULE 10B5-2: A CALL FOR REVITALIZING THE COMMISSION'S EFFORTS IN THE WAR ON INSIDER TRADING

I. INTRODUCTION

It is well known that the Securities and Exchange Commission ("SEC" or the "Commission") is the administrative agency that regulates insider trading in the United States' financial markets.¹ It is also well known that insider trading law is notoriously difficult to understand, and even more difficult to apply.² It is less well known, however, that the Commission itself adds to this confusion and difficulty through its hesitancy to utilize pleading rules designed to lighten its burden in effecting its insider trading enforcement program (the "Program").³ The Program is the Commission's effort to outlaw trading on material, nonpublic information by corporate insiders and outsiders which harms investors in the United States.⁴ Although its goal is clear, the Program is plagued by a combination of poor Congressional guidance, courts that struggle with applying a legal fiction (the insider trading prohibition), and a disjointed Commission.⁵ As a result, the prohibition on insider trading continues to be difficult to articulate and enforce. This is a situation detrimental to the Commission, the courts, and the market players—that is, the buyers and sellers of financial securities.

1. Securities and Exchange Commission, <http://www.sec.gov/answers/secwork.htm> (last visited July 25, 2009) (stating that the SEC is charged with enforcing the securities laws to ensure fairness and penalize wrongdoers).

2. JAMES D. COX ET AL., SECURITIES REGULATION 879-80 (5th ed. 2006) ("As anyone in a course on securities regulation is probably already well aware, Congress has never defined with any degree of precision the nature of the insider trading prohibition.").

3. See J. Scott Colesanti, *"We'll Know It When We Can't Hear It": A Call for a Non-Pornography Test Approach to Recognizing Non-Public Information*, 35 HOFSTRA L. REV. 539, 542 (2006) (noting that the Program refers to the SEC's insider trading enforcement efforts).

4. See Selective Disclosure and Insider Trading, Securities Act Release No. 7787, Exchange Act Release No. 42,259, Investment Company Act Release No. 24,209 (proposed Dec. 20, 1999) (noting that the Commission utilizes the anti-fraud provisions of the securities laws to prohibit "the fraudulent misuse of material nonpublic information."); see also Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1330-31 (1999) (regarding the SEC's insider trading enforcement program as integral to the Commission's identity).

5. See Jill E. Fisch, Letter to the Editor, *The Muddle of Insider Trading Regulation*, N.Y. TIMES, Nov. 24, 1991, at F11 (discussing the contributions of the Commission, the courts, and Congress to the confusion surrounding enforcement of the insider trading prohibition).

This Note urges the SEC to utilize a pleading rule it has recently enacted to clarify one particular aspect of insider trading regulation. Rule 10b5-2⁶ was adopted in 2000 in an effort by the Commission to solve the “duty problem.”⁷ The duty problem is the uncertainty surrounding which relationships courts recognize as creating a fiduciary or fiduciary-like duty under the misappropriation theory of insider trading.⁸ The duty problem burdens the Commission, courts, and market players because determining if an investor is in such a relationship is difficult given the present state of the securities laws.⁹ While Rule 10b5-2 was enacted to provide a solution to the duty problem, the Commission has created the opposite result by failing to properly utilize the Rule. As a result, the duty problem remains unresolved.

There are two important factors to consider when analyzing the Commission’s usage of Rule 10b5-2. First, the rules adopted by the SEC are granted deference by the courts.¹⁰ This is paramount for Rule 10b5-2 because it highlights the legal significance implicit in the Rule. SEC Rules are granted judicial deference unless it is determined by a court that the Rule lacks merit or is outside the scope of the Commission’s authority.¹¹ As of now, Rule 10b5-2 continues to be granted judicial deference.¹² As a result, Rule 10b5-2 has significant legal value for the Commission, and the market players are bound by its provisions.¹³ In addition, any proposed solution through tweaked or modified language to Rule 10b5-2 can be presumed as within the grant of Congressional authority given to the Commission through Section 10(b) of the Securities Exchange Act (“Exchange Act”).¹⁴

6. 17 C.F.R. § 240.10b5-2 (2008).

7. See Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599, 73 SEC Docket 3, 19 (Aug. 15, 2000) (stating that Rule 10b5-2 was passed in order to clearly define the relationships which should create a fiduciary duty under the misappropriation theory).

8. Thomas M. Madden, O’Hagan, *10b5-2, Relationships, and Duties*, 4 HASTINGS BUS. L.J. 55, 70, 73 (2008). Madden articulates the duty problem as: “[W]hose duties are at issue? What relationships matter?” *Id.* at 70.

9. *Id.* at 70-72.

10. *Batterton v. Francis*, 432 U.S. 416, 424-26 (1977); see also *Chevron U.S.A. v. Natural Res. Def. Council*, 467 U.S. 837, 843-44 (1984). The SEC’s Rules are granted “controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.” *Id.* at 844.

11. *Batterton*, 432 U.S. at 426.

12. Madden, *supra* note 8, at 74-75 (discussing that Rule 10b5-2 has been overlooked, but still remains a valid piece of SEC legislation).

13. 15 U.S.C. § 78j(b) (2008). This statute enacted Section 10(b) of the Securities Exchange Act of 1934, which gives the SEC the authority to enact Rules, and gives legal value to these Rules. *Id.*

14. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976) (noting that the “scope [of SEC Rules] cannot exceed the power granted the Commission by Congress under § 10(b)”).

The second factor is that the SEC is not required to plead Rule 10b5-2 for the courts to apply the Rule in misappropriation theory cases.¹⁵ Rather, the Commission must simply allege facts that prove that the relationship in question creates a fiduciary or fiduciary-like duty.¹⁶ This is difficult to accomplish, however, when the relationship is not one that traditionally gives rise to a fiduciary duty.¹⁷ Therefore, it is important to urge the Commission to consistently plead Rule 10b5-2 because the duty problem cannot be fairly resolved without consistent application of the Rule. This Note outlines how the Commission lost its focus and how it can revitalize its tactics to achieve resolution of the duty problem.

Part II of this Note discusses the history of insider trading regulation and provides an in-depth analysis of the development of the misappropriation theory. This section highlights the pertinent case law and history which culminated in the enactment of Rule 10b5-2.

Part III details the Commission's usage of the Rule since 2000 through a comparative analysis with the SEC's treatment of Rule 10b5-1. It also discusses the patchwork application the Commission has given to Rule 10b5-2 since enacting the Rule.

Part IV provides an analysis of two currently pending insider trading cases involving the duty problem to highlight the present issues facing the Commission. In conclusion, this Note proposes two solutions for solving the duty problem.

II. TRADITIONAL VAGARIES OF INSIDER TRADING LAW AND THE SEC'S RESPONSE

A. *Two Theories of Insider Trading Law and the Duty Problem*

There is no federal statute or law in the United States explicitly prohibiting insider trading.¹⁸ Rather, insider trading regulation is a

15. See SEC v. Talbot, 430 F. Supp. 2d 1029, 1061 (C.D. Cal. 2006). The *Talbot* court applied Rule 10b5-2; however, the Rule was not pled in the Complaint against Talbot. See Complaint at 2, 7, SEC v. Talbot, 430 F. Supp. 2d 1029, (C.D. Cal. 2006) (No. CV-04-4556) (making no mention of Rule 10b5-2).

16. See United States v. O'Hagan, 521 U.S. 642, 652-53 (1997) (holding that the misappropriation theory requires proof that the relationship in question creates a fiduciary duty).

17. See Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599, 73 SEC Docket 3, 28 (Aug. 15, 2000) (noting that Rule 10b5-2 was enacted to clarify the relationships which should give rise to a fiduciary duty for the purposes of insider trading liability).

18. COX ET AL., *supra* note 2, at 879; Carol B. Swanson, *Insider Trading Madness: Rule 10b5-1 and the Death of Sciento*, 52 U. KAN. L. REV. 147, 158 (2003) (noting that the prohibition on insider trading remains undefined); see also Fisch, *supra* note 5, at F11.

synthesis of Section 10(b) of the Exchange Act and judicial decisions, acting in conjunction with one another.¹⁹ Pursuant to its authority under the Exchange Act, the Commission enacted Rule 10b-5 in 1942,²⁰ the generic anti-fraud provision from which all regulation of insider trading has sprung.²¹ It took another two decades before the landmark 1961 SEC administrative decision of *In re Cady, Roberts & Co.*,²² which first outlawed trading on inside information as a violation of Rule 10b-5.²³ *Cady, Roberts* in turn led to *SEC v. Texas Gulf Sulphur*,²⁴ the first case in which the federal courts recognized insider trading to be a violation of Rule 10b-5.²⁵ *Texas Gulf Sulphur* held that employees, in addition to corporate officers and directors, are insiders that have a duty to disclose inside information or abstain from trading on such information.²⁶ After *Texas Gulf Sulphur*, it became clear that the prohibition on insider trading was here to stay. In the 1980s, however, the Commission was dealt a setback when it began to charge investors who were not traditional insiders with violations of Rule 10b-5.

It is important to acknowledge that the goal of the Commission in extending Rule 10b-5 was not to win civil or criminal convictions²⁷

19. COX ET AL., *supra* note 2, at 879-80.

20. Rule 10b-5 provides:

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.

17 C.F.R. § 240.10b-5 (2008).

21. Robert Steinbuch, *Mere Thieves*, 67 MD. L. REV. 570, 572 (2008). Steinbuch notes that Rule 10b-5 "is considered the primary SEC mechanism for regulating securities fraud, including insider trading." *Id.*; see also Ethan J. Leib, *Friendship & the Law*, 54 UCLA L. REV. 631, 692 (2007) (referring to the insider trading prohibition as emanating from Rule 10b-5); Swanson, *supra* note 18, at 150. Swanson states that Rule 10b-5 "is the heart of insider trading prohibitions." *Id.*

22. 40 S.E.C. 907 (1961).

23. *Id.* at 913-14 (holding that insider trading is fraud under Section 10b of the Securities Exchange Act of 1934 and Rule 10b-5, and that corporate insiders have a duty to disclose insider information or abstain from trading).

24. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005 (1971).

25. *Id.* at 848, 864.

26. See *id.* at 848.

27. The SEC may only bring civil actions. As Carr explains:

When the SEC suspects someone of criminal violations . . . it has discretion to prepare a formal referral to the Department of Justice. The SEC may bring civil and administrative proceedings to investigate potential violations, but the Department of Justice has sole jurisdiction to institute criminal proceedings under the Exchange Act.

against every single person who engages in insider trading. Rather, the goal of the Commission, and that of the Program since the days of *Cady, Roberts*, has been to promote fairness in the markets for buyers and sellers of financial securities.²⁸ Indeed, the importance of ensuring fairness is underscored by the Commission's devotion of a substantial amount of resources towards policing insider trading.²⁹ The importance of fairness in the markets goes beyond the aims of the Program, as fairness in the United States financial markets is cited as a major reason for their ongoing success.³⁰ Thus, when analyzing the duty problem and Rule 10b5-2, it is important to keep in mind that fairness is the goal of the Program. Fairness is achieved through producing a concise, predictable, and firm body of case law that provides clear guidance for the courts and the market players.

1. The Classical Theory

The 1980s saw two landmark decisions from the Supreme Court dealing setbacks to the Program: *Chiarella v. United States*³¹ and *Dirks v. SEC*.³² In *Chiarella*, the defendant worked for a printer of financial documents and handled paperwork involving corporate mergers and acquisitions.³³ Although the names of the target companies were

Brian J. Carr, Note, *Culpable Intent Required for All Criminal Insider Trading Convictions After United States v. O'Hagan*, 40 B.C. L. REV. 1187, 1191 (1999); see also 17 C.F.R. § 202.5(f) (2008) (codifying the express reservation of criminal authority under the Exchange Act to the Department of Justice).

28. The SEC explains its ruling as a result of:

the inherent unfairness involved where a party takes advantage of such [inside] information knowing it is unavailable to those with whom he is dealing. . . . [O]ur task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited.

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

29. Mr. Newkirk states that "[a]n essential part of our regulation of the securities market is the vigorous enforcement of our laws against insider trading, an enforcement program, the Chairman noted, that 'resonate[s] especially profoundly' among American investors." Thomas C. Newkirk, Assoc. Dir., SEC Div. of Enforcement, Address at the 16th International Symposium on Economic Crime: Insider Trading—A U.S. Perspective (Sept. 19, 1998), available at <http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm>. (second alteration in original).

30. Silkenat notes that:

[O]ne of the main reasons that capital is available in such [large] such [sic] quantities in the U.S. markets is basically that the investor trusts the U.S. markets to be fair. Fairness is a major issue. Even though it sounds simplistic, it is a critical factor and one that is absent, really to a surprising degree, in many of the sophisticated foreign markets.

James R. Silkenat, *Overview of U.S. Securities Markets and Foreign Issuers*, 17 FORDHAM INT'L L.J. S4, S6 (1994).

31. 445 U.S. 222 (1980).

32. 463 U.S. 646 (1983).

33. *Chiarella*, 445 U.S. at 224.

replaced with code words on the financial documents, the defendant was able to decipher the code words, and traded on this information to his profit.³⁴ After settling civil charges with the SEC, the defendant was convicted for a criminal violation of Rule 10b-5.³⁵ The majority in *Chiarella*, when it reversed the defendant's conviction, reaffirmed what is known as the classical theory of insider trading.³⁶ Under the classical theory, an investor is guilty of insider trading if he is a corporate insider³⁷ who trades on the basis of material, non-public information in breach of a duty of trust and confidence—that is, a fiduciary duty—between the insider and the shareholders of the harmed company.³⁸ Thus, in *Chiarella*, the defendant was not liable for insider trading because he was not a corporate insider and had no fiduciary duty to the shareholders of the company injured by his trading.

Nonetheless, the ruling in *Chiarella* did not completely shut the door to insider trading liability for investors (such as the defendant) who are not traditional insiders. The majority noted that the dissent's discussion of a different theory of insider trading may have merit, but could not apply because it was not presented at trial to the jury.³⁹ The theory discussed by the dissent was the misappropriation theory, which mandates that any investor “who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading” on that information.⁴⁰

While the classical theory was intended for insiders, the misappropriation theory was developed to apply to “outsiders.”⁴¹ Insiders are defined as those individuals who have a fiduciary duty to the shareholders of a corporation as a result of their access to confidential information through their employment and/or association with the corporation.⁴² Outsiders are defined as those individuals “who have access to confidential information that will affect th[e] corporation's security price when revealed, but who owe no fiduciary or other duty to

34. *Id.*

35. *Id.* at 224-25.

36. *See id.* at 234-35.

37. *Dirks*, 463 U.S. at 654-55. The Court identified, in addition to employees, directors, and officers of a corporation, any professional working for the corporation in a temporary capacity, such as a lawyer, accountant, underwriter, or consultant, as being a corporate insider. *Id.* at 655 n.14.

38. *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997); *see also* *SEC v. Clark*, 915 F.2d 439, 443 (9th Cir. 1990) (defining the classical theory of insider trading as an insider of a corporation trading on material, nonpublic information in violation of a fiduciary duty to the corporation's shareholders).

39. *Chiarella*, 445 U.S. at 235-37 & n.20.

40. *Id.* at 240 (Burger, J., dissenting).

41. *Clark*, 915 F.2d at 443.

42. *See O'Hagan*, 521 U.S. at 652.

that corporation's shareholders.'"⁴³ The defendant in *Chiarella* was clearly an outsider. Thus, the ruling in *Chiarella* provided a major setback for the Program, because it held that absent a fiduciary duty to the shareholders of the harmed company, the Commission was unable to successfully charge outsiders for Rule 10b-5 violations.

The Court decided *Dirks v. SEC* after *Chiarella* and focused on a slightly different aspect of insider trading. In *Dirks*, the Court applied the principle of the classical theory to prohibit tipper/tippee trading.⁴⁴ Under tipper/tippee trading, liability may be found when investors (tippees) receive inside information from an insider (tipper) who has a fiduciary duty to disclose or abstain from trading, and the tippee trades on the information to his profit.⁴⁵ The key factor in determining whether or not there is a breach of fiduciary duty is if the tipper will receive some sort of personal benefit from making the tip.⁴⁶ The tipper and the tippee are enmeshed in liability, since a breach of fiduciary duty by the tipper creates the derivative breach in the tippee.⁴⁷ Thus, if the tipper cannot be found to have breached a fiduciary duty, the tippee is likewise relieved of liability.⁴⁸

The defendant in *Dirks* was a tippee: a securities analyst who was tipped by a former officer of Equity Funding of America that the company was engaged in fraudulent activities.⁴⁹ The tipper provided this information solely to expose the fraud occurring at Equity Funding.⁵⁰ The defendant tried to verify this information, and in the course of his investigation, told several people about Equity Funding's problems, and they in turn traded on the information to their profit.⁵¹ Ultimately, the defendant's convictions for violating Rule 10b-5 as a tippee were reversed, since the tipper had not received a personal benefit from giving

43. *Id.* at 653 (alteration in original) (quoting Brief of the United States at 14, *United States v. O'Hagan*, 521 U.S. 642 (1997) (No. 96-842)).

44. *See Dirks*, 463 U.S. at 659-60.

45. *Id.*

46. *Id.* at 661-62.

47. The *Dirks* Court states that:

Whether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure. . . . Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.

Id. at 662.

48. *Id.*

49. *Id.* at 648-49.

50. *Id.* at 667-69.

51. *Id.* at 649.

the tip, and therefore did not breach a fiduciary duty to Equity Funding.⁵²

The question remaining after *Chiarella* and *Dirks* was the probable result when a combination of the issues in both cases manifested themselves.⁵³ For instance, the question of liability under Rule 10b-5 is unclear when an outsider with material, nonpublic information tips his friend about a merger and the friend trades on the information for a profit. The result would be that neither the outsider nor the friend is liable since *Chiarella* said that outsiders may misappropriate inside information as long as they do not breach a fiduciary duty to the source of their information. Therefore, under *Dirks*, the outsider could not be a tipper, because he has no duty to disclose or abstain from trading. The result in this hypothetical is disastrous for the Program, because it means outsiders and their tippees have free reign to engage in insider trading, profit from it, and suffer no repercussions. The goal of promoting fairness among investors is greatly hindered in this scenario. As was inevitable, this hypothetical soon became reality.

2. The Duty Problem

While the misappropriation theory struggled to gain acceptance by the Supreme Court,⁵⁴ the early 1990s saw the lower federal courts grappling with the theory as well. While agreeing in principle with the dissent in *Chiarella*, the Second Circuit promulgated a more restricted version of the misappropriation theory.⁵⁵ In the Second Circuit's version, Rule 10b-5 is violated whenever a person "misappropriates material nonpublic information in breach of a fiduciary duty or similar relationship of trust and confidence and uses that information in a securities transaction."⁵⁶ This version of the misappropriation theory is where the duty problem began, as it requires the Commission to show that the outsider has breached a fiduciary duty to the source of his information. In comparison, the dissent in *Chiarella* would have all

52. *Id.* at 666-67.

53. See Donald C. Langevoort, *Investment Analysts and the Law of Insider Trading*, 76 VA. L. REV. 1023, 1034-35 (1990). Langevoort states that "the *Chiarella-Dirks* construct has been criticized as setting an unduly narrow scope to the insider trading prohibition with respect to two problems: tipping liability and trading by insiders in the shares of some other issuer." *Id.* at 1034.

54. *Carpenter v. United States*, 484 U.S. 19, 24 (1987) (discussing that the misappropriation theory provided the basis for the defendant's conviction). *But see* Madden, *supra* note 8, at 59 (discussing that the Supreme Court did not adopt the misappropriation theory in *Carpenter* because the court ruled 4-4 to affirm the lower court decision, and tie votes in the Supreme Court have no precedential value).

55. See *United States v. Chestman*, 947 F.2d 551, 566 (2d Cir. 1991).

56. *Id.*

outsiders automatically disclose or abstain from trading, regardless of whether a fiduciary duty has been breached.⁵⁷

The Second Circuit's 1991 decision in *United States v. Chestman* presented the question left after *Dirks* and *Chiarella*.⁵⁸ In *Chestman*, the court dismissed the notion that there was an implied duty of trust or confidence between a husband and wife.⁵⁹ The defendant, the tippee, was a stockbroker who gained information from his client, the tipper, that Waldbaums, Inc. would be acquired.⁶⁰ The client's wife and her family owned the majority equity interest in Waldbaums.⁶¹ The wife was told by her family not to tell anyone other than her husband of the pending sale of Waldbaums.⁶² She told her husband, an outsider to the company, who then informed the defendant.⁶³ The main question was whether the relationship between the husband and wife consisted of an agreement to maintain information in confidence such that a fiduciary duty was owed to the wife. If the husband tipper did not owe a fiduciary duty to his wife, who was the source of his information, then no liability could flow to the defendant tippee.⁶⁴ The court denied that the relationship between the husband and wife created a fiduciary duty, and dismissed the charges against the defendant.⁶⁵ In so ruling, the *Chestman* court solidified the duty problem for the Commission.

In *United States v. Cassese*,⁶⁶ another case highlighting the duty problem, the defendant was in talks to have his company purchased by a competitor, Compuware Corp.⁶⁷ The defendant was given a confidentiality agreement by Compuware to protect the secrecy of their negotiations, which he failed to sign.⁶⁸ Compuware then informed the defendant that it was backing out and was instead purchasing DPRC, another competitor.⁶⁹ The defendant traded on this information to his profit.⁷⁰ The court held for the defendant because there was no fiduciary duty between him and Compuware, and the lack of a confidentiality agreement acted as an explicit rejection of any such duty by the

57. *Chiarella v. United States*, 445 U.S. 222, 240 (1980) (Burger, J., dissenting).

58. *Chestman*, 947 F.2d at 551.

59. *Id.* at 571.

60. *Id.* at 555.

61. *Id.*

62. *Id.*

63. *Id.*

64. *Dirks v. SEC*, 463 U.S. 646, 661-62 (1983).

65. *Chestman*, 947 F.2d at 571.

66. 273 F. Supp. 2d 481 (S.D.N.Y. 2003).

67. *Id.* at 483.

68. *Id.*

69. *Id.* at 484.

70. *Id.*

defendant.⁷¹ Thus, the court in *Cassese* essentially ruled that outsiders are permitted to engage in insider trading, so long as they ignore confidentiality agreements, never agree to keep information confidential, and have no history of maintaining confidential information.

3. The Misappropriation Theory Gains Recognition

Though the Commission suffered setbacks in *Chestman* and *Cassese*, thereby perpetuating the duty problem, in 1997 it won an important victory in the Supreme Court by gaining recognition of the misappropriation theory.⁷² In *United States v. O'Hagan*, the defendant was the "quintessential outsider" that the Program sought to cover.⁷³ He was an attorney whose law firm was representing Grand Met PLC in their acquisition of Pillsbury Co.⁷⁴ The defendant was not personally working on the deal, yet knew about the merger and cornered the entire market for Pillsbury call options.⁷⁵ He had no fiduciary duty to Pillsbury, and therefore, if he traded on this information, the classical theory would be powerless to prohibit his actions.⁷⁶ The defendant sold his stock and exercised the options after the merger announcement, making a \$4.3 million profit.⁷⁷ Thus, the *O'Hagan* Court was backed against a wall: it had to either adopt the misappropriation theory, or allow an attorney to walk free after making \$4.3 million by betraying the trust of his firm's clients.⁷⁸

The *O'Hagan* Court chose to adopt the misappropriation theory, but not the version discussed by the dissent in *Chiarella*.⁷⁹ Instead, the Court adopted the more restricted version promulgated by the Second Circuit.⁸⁰ This version prohibits "trading on the basis of information that the wrongdoer converted to his own use in violation of some fiduciary, contractual, or similar obligation to the owner or rightful possessor of the information."⁸¹ Most importantly, the decision in *O'Hagan* stressed

71. *Id.* at 486-87.

72. *United States v. O'Hagan*, 521 U.S. 642, 665-66 (1997).

73. Steinbuch, *supra* note 21, at 587 ("O'Hagan was a quintessential outsider because he worked for the firm representing the acquirer when he traded options of the target.").

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

75. *Id.* at 647-48.

76. *Id.* at 653 n.5.

77. *Id.* at 648.

78. See Steinbuch, *supra* note 21, at 586-87 (discussing that the *O'Hagan* Court was faced with determining the merit of the Eighth Circuit's rejection of the misappropriation theory).

79. *O'Hagan*, 521 U.S. at 655 n.6.

80. See *United States v. Chestman*, 947 F.2d 551, 566 (2d Cir. 1991).

81. Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 122 (1984); see also Steinbuch, *supra* note 21, at 587-88 (discussing the misappropriation theory as adopted by the *O'Hagan* Court).

that the misappropriation theory was meant to apply to outsiders who have access to confidential information that would affect the price of a corporation's stock, but have no fiduciary duty to that corporation.⁸² According to the *O'Hagan* Court, the breach of fiduciary duty only needs to be shown between the outsider and the source of his information.⁸³

While *O'Hagan* was a victory for the Commission, the decision perpetuated the duty problem because the Court failed to clearly define which types of relationships would satisfy the fiduciary duty requirement of the misappropriation theory.⁸⁴ In addition, the misappropriation theory as adopted in *O'Hagan* has been met with a fair share of criticism.⁸⁵ Specifically, critics argue that *O'Hagan* does nothing to solve the problem that no statute exists to define insider trading liability for outsiders.⁸⁶ They feel that "[t]he piecemeal judicial elaboration of the doctrine of insider trading has created an amorphous offense"⁸⁷ Others noted that the misappropriation theory adopted by the *O'Hagan* Court was flawed at its outset.⁸⁸ Finally, Justice Thomas penned an impassioned dissent in the *O'Hagan* decision arguing against the adoption of any form of the misappropriation theory.⁸⁹ Despite criticisms of the decision, *O'Hagan* adopted the misappropriation theory and recognized that at least some outsiders should be covered by the

82. Justice Ginsburg ruled that:

the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate "outsider" in breach of a duty owed not to a trading party, but to the source of the information. The misappropriation theory is thus designed to "protec[t] the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect th[e] corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders."

O'Hagan, 521 U.S. at 652-53 (alteration in original) (quoting Brief of the United States at 14, *United States v. O'Hagan*, 521 U.S. 642 (1997) (No. 96-842)).

83. *Id.* at 652.

84. Steinbuch, *supra* note 21, at 588-89.

85. *Id.* at 589; see also Randall W. Quinn, Comment, *The Misappropriation Theory of Insider Trading in the Supreme Court: A (Brief) Response to the (Many) Critics of United States v. O'Hagan*, 8 FORDHAM J. CORP. & FIN. L. 865, 882, 884, 888-90 (2003) (detailing several criticisms of the misappropriation theory).

86. David M. Brodsky & Daniel J. Kramer, *A Critique of the Misappropriation Theory of Insider Trading*, 20 CARDOZO L. REV. 41, 75, 77, 79 (1998).

87. *Id.* at 44.

88. Colesanti, *supra* note 3, at 556-57. Colesanti notes that "[c]ritics were quick to point out that, by focusing on *any* fiduciary duty, the decision [in *O'Hagan*] hopelessly ties a federal prohibition to a state law concept." *Id.* at 556.

89. *United States v. O'Hagan*, 521 U.S. 642, 691 (1997) (Thomas, J., dissenting). ("The absence of a coherent and consistent misappropriation theory . . . is particularly problematic in the context of this case. . . . [I]n this case we do not even have a formal regulation embodying the agency's misappropriation theory.")

Program. Nonetheless, after *O'Hagan*, it was clear that further action was needed in light of the problems with the misappropriation theory as adopted by the Court.

B. The Commission Adopts Rule 10b5-2 to Address the Duty Problem

1. The SEC's Arsenal Gets a Boost

The SEC adopted Rule 10b5-2⁹⁰ in 2000 to provide clarity with regards to which relationships should create a fiduciary duty to satisfy the misappropriation theory.⁹¹ In addition, the Commission provided the Rule with a vague, open-ended Preliminary Note that specifically designated the three categories in the Rule as non-exclusive.⁹² The Rule should in theory encompass all outsiders who misappropriate inside information.⁹³ This, in turn, would allow the SEC to effectively solve the duty problem, as there would then be no issue over whether a given relationship creates a fiduciary duty. Unfortunately, Rule 10b5-2 has not been the knight in shining armor that the Commission had desired. In fact, even before Rule 10b5-2 had a chance to be utilized, the Rule was

90. Rule 10b5-2 specifies the following list of duties:

(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 (2008).

91. Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599 (Aug. 15, 2000).

92. The Preliminary Note to Rule 10b5-2 states that:

This section provides a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the "misappropriation" theory of insider trading under Section 10(b) of the Act and Rule 10b-5. 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.

17 C.F.R. § 240.10b5-2.

93. Madden, *supra* note 8, at 72-73.

met with a slew of negative criticism by the academic, legal, and financial communities.

2. Rule 10b5-2 Gets a Poor Review

During the SEC's proposal period for Rule 10b5-2,⁹⁴ it got a review that Roger Ebert would describe as two thumbs down.⁹⁵ Time has not changed the opinion of most critics, and Rule 10b5-2 has been continually lambasted for a variety of reasons. For instance, one critic feels that the Rule has been overlooked and cannot be successful in the long run due to the lack of usage it has received since its passage.⁹⁶ A more troubling criticism has been that the Rule is outside the scope of the Commission's authority.⁹⁷ This argument criticizes Rule 10b5-2 for directly contradicting two rulings of the Supreme Court in *Chiarella* and *Dirks*.⁹⁸ Another critic feels that the *Cassese* ruling would not have been affected by Rule 10b5-2 because the confidentiality agreement was not signed, and there had been no history of keeping information confidential between the parties.⁹⁹

One commentator goes further, and criticizes the Rule for effectively overturning the ruling in *Chestman*.¹⁰⁰ The commentator argues that the SEC has overstepped its authority and Rule 10b5-2 will not be granted deference since it directly contrasts an en banc ruling of the Second Circuit.¹⁰¹ Yet another commentator states that adoption of the Rule was completely unnecessary since the Rule was codifying relationships that had always created a fiduciary duty.¹⁰² Indeed, while contemplating adoption of the Rule, the SEC received feedback in the

94. 17 C.F.R. § 200.80(e)(8) (2008) (the SEC allows the public to obtain copies of, among other items, all the documentation gathered in the rule proposal process); see also J. Scott Colesanti, *The SEC's Comment Policy and the Economic Crisis*, 241 N.Y. L.J. 33 (2009) (noting that the SEC has a proposal period when enacting Rules. This allows any member of the public to send the Commission a letter with their thoughts on the proposed Rule, and the Commission makes all letters publicly available for viewing).

95. See Letter from Corp., Fin. & Sec. Law Section, D.C. Bar, to Jonathan G. Katz, Sec'y, SEC (Apr. 28, 2000), available at <http://www.sec.gov/rules/proposed/s73199/dcbar1.htm> (advising against adopting sections (b)(1) and (b)(2) of Rule 10b5-2); see also Letter from Stuart Sinai to Jonathan G. Katz, Sec'y, SEC (Mar. 22, 2000), available at <http://www.sec.gov/rules/proposed/s73199/sinai1.htm> (advocating against the adoption of any form of Rule 10b5-2).

96. Madden, *supra* note 8, at 74.

97. Ray J. Grzebielski, *Friends, Family, Fiduciaries: Personal Relationships as a Basis for Insider Trading Violations*, 51 CATH. U. L. REV. 467, 492 (2002).

98. *Id.*

99. John C. Coffee, Jr., *Insider Trading: Expansion and Contraction*, N.Y. L.J., Jan. 19, 2006, at 5.

100. Marc I. Steinberg, *Insider Trading, Selective Disclosure, and Prompt Disclosure: A Comparative Analysis*, 22 U. PA. J. INT'L ECON. L. 635, 646-47 (2001).

101. *Id.* at 647.

102. Steinbuch, *supra* note 21, at 597.

form of public letters written by various individuals and institutions in the financial and legal community. These letters mirrored the criticisms of academia and counseled against adoption of the Rule.¹⁰³

The critics of Rule 10b5-2 all raise valid and important points, and their sentiments cannot be easily dismissed. The Rule, however, is in response to a gap in the law that was dealt to the Commission by the Supreme Court. Therefore, while all of the critics raise fair points, they miss the bigger picture. The Commission's efforts are laudable in the battle against insider trading, and Rule 10b5-2 is necessary to combat the duty problem.¹⁰⁴

3. The Courts Embrace the Rule

Prior to the Rule's official enactment, courts took notice of Rule 10b5-2 in cases such as *SEC v. Yun*.¹⁰⁵ The defendant in *Yun* was the ex-wife of the president of Scholastic Book Fairs, Inc., and had gained confidential information about Scholastic from her ex-husband regarding the company's earning statements for the next quarter.¹⁰⁶ She agreed to keep the information confidential, and was explicitly told not to communicate it to anyone.¹⁰⁷ Despite these prohibitions, the defendant tipped her friend, who then traded on the information to his profit.¹⁰⁸ The SEC brought suit, charging that the defendant was an outsider who had a fiduciary duty to her ex-husband, and she breached that duty when she tipped the confidential information to her friend.¹⁰⁹ The defendant countered by arguing that no fiduciary duty existed with her ex-husband.¹¹⁰ In ruling for the SEC, the *Yun* court held that the evidence proving that the defendant had agreed to keep the information confidential was sufficient to establish a fiduciary duty between the defendant and her ex-husband.¹¹¹

The decision in *Yun* was consistent with the SEC's position that this kind of relationship should be classified as creating a fiduciary duty.¹¹² In a footnote, the court stated that their decision was bolstered by the

103. See *supra* note 95 and accompanying text.

104. See Colesanti, *supra* note 3, at 580-81 (commending the SEC for the job they have done in regulating insider trading).

105. 327 F.3d 1263 (11th Cir. 2003).

106. *Id.* at 1267.

107. *Id.*

108. *Id.* at 1268.

109. *Id.* at 1270.

110. *Id.*

111. *Id.* at 1272-74 & n.23.

112. 17 C.F.R. § 240.10b5-2(b)(3) (2008).

language of Rule 10b5-2.¹¹³ Indeed, the court felt that the ruling in *Chestman* did not go far enough in recognizing the degree to which family members expect their conversations to remain confidential.¹¹⁴ The discussion of Rule 10b5-2 in *Yun* signaled that courts were willing to embrace the Rule.¹¹⁵ The relevant conduct in *Yun* occurred in 1997, however, and therefore Rule 10b5-2 could not be utilized against the defendant.

Other courts have engaged in similar analyses. In *United States v. Kim*,¹¹⁶ the defendant belonged to a professional organization which required members to comply with a confidentiality agreement as a condition of membership.¹¹⁷ The defendant misappropriated confidential information from another member, and traded on this information to his profit.¹¹⁸ The court held that the defendant did not breach a fiduciary duty to his fellow member because there was no explicit agreement to keep the information confidential.¹¹⁹ The court, however, stated that if Rule 10b5-2 had been in effect, the defendant would have had to concede to breaching a fiduciary duty.¹²⁰ The court noted it would then be inclined to accept the government's position that the defendant violated the misappropriation theory.¹²¹ The implication of the discussion in *Kim* cannot be understated. The clear statement that Rule 10b5-2 could have led to a different result in *Kim* demonstrates the utility of the Rule.

Finally, another court again determined that Rule 10b5-2 would be useful, this time while ruling on a summary judgment motion.¹²² In *SEC v. Goodson*, the defendant learned from his wife that her company was going to be acquired, informed his father of this news, and then encouraged his father to buy options on the company's stock.¹²³ The court denied the defendant's motion for summary judgment, holding that a jury could find a violation of a fiduciary duty to his wife.¹²⁴ The court also noted that there was an issue of fact over whether the defendant was

113. *Yun*, 327 F.3d at 1273 n.23.

114. *Id.*

115. M. Anne Kaufold, Note, *Defining Misappropriation: The Spousal Duty of Loyalty and the Expectation of Benefit*, 55 MERCER L. REV. 1489, 1498-99 (2004).

116. 184 F. Supp. 2d 1006 (N.D. Cal. 2002).

117. *Id.* at 1008.

118. *Id.* at 1008-09.

119. *Id.* at 1015.

120. *Id.* at 1014.

121. *Id.* at 1014-15.

122. *SEC v. Goodson*, No. 99CV2133, 2001 WL 819431, at *1, *3 (N.D. Ga. Mar. 6, 2001).

123. *Id.* at *1.

124. *Id.* at *4.

told the information “in confidence” by his wife.¹²⁵ In coming to this conclusion, the court discussed Rule 10b5-2, noting that it creates a federal fiduciary duty for spouses, and that this codification was necessary to create uniformity in the securities laws.¹²⁶ Thus, while the critics of Rule 10b5-2 were skeptical,¹²⁷ courts such as those in *Yun*, *Kim*, and *Goodson* were ready to accept the Rule to provide clarity in the securities laws.

III. A PATCHWORK APPROACH: RULE 10B5-2 APPLIED

It seemed that the Commission would be able to resolve the duty problem with Rule 10b5-2. Unfortunately, this has not occurred. The reason is not because the courts have determined that the Rule is beyond the scope of the Commission’s authority, or inconsistent with precedent.¹²⁸ If either were the case, Rule 10b5-2 would essentially be useless, and the Commission would be back in the same position they were in after the decision in *Chestman*. The true reason that Rule 10b5-2 has not been effective is much simpler and yet more troubling. The Commission itself is the root cause of the problem.

The SEC has been inconsistent in pleading Rule 10b5-2 in cases where it is unclear if the relationship in question creates a fiduciary duty. This patchwork approach to pleading Rule 10b5-2 has resulted in the continuance of the duty problem, since there remains uncertainty over which relationships satisfy the misappropriation theory. To exacerbate the situation, Rule 10b5-2 is not the only weapon in the Commission’s arsenal that has been misused. Rule 10b5-1,¹²⁹ which was passed with Rule 10b5-2 in 2000, has received similarly inconsistent treatment from the Commission.

A. Rule 10b5-1: A Troubling Pattern

When charged with insider trading, a common defense by the accused is that they were planning on buying or selling the securities in question prior to coming into possession of the material, nonpublic insider information.¹³⁰ To combat this defense, the SEC took the position

125. *Id.*

126. *Id.* at *3.

127. There are a few scholars in support of Rule 10b5-2, but they are in the minority. *See, e.g.*, Quinn, *supra* note 85, at 898 (expressing support for Rule 10b5-2).

128. Madden, *supra* note 8, at 74. Madden believes that “Rule 10b5-2 has been blatantly overlooked” since its adoption, but remains a valid Rule for the courts to consult. *Id.*

129. 17 C.F.R. § 240.10b5-1 (2008).

130. MARC I. STEINBERG, SECURITIES REGULATION 691 (5th ed. 2008); *see, e.g.*, Brief of Respondent-Appellee at 11-12, SEC v. Adler, 137 F.3d 1325 (11th Cir. 1998) (No. 96-6084).

that trading in securities while merely possessing material, nonpublic information is sufficient to meet the scienter¹³¹ requirement of Rule 10b-5.¹³² The Second Circuit agreed, and in 1993 adopted the possession standard for scienter.¹³³ However, not all of the circuits agreed with the Second Circuit that possession is the correct standard for scienter. In 1998, the Eleventh Circuit held in *SEC v. Adler* that proof of use rather than mere possession was required for proving scienter.¹³⁴ Simply put, the *Adler* court wanted the SEC to show that the defendant's knowledge of material, nonpublic information was a substantial factor in his decision to purchase or sell the securities at the time and price they were sold.¹³⁵ In addition, the Ninth Circuit likewise concluded that the proper standard for scienter was use and not possession.¹³⁶ Thus, the circuits were divided over whether use or possession was the proper scienter standard for Rule 10b-5 violations.

To solve the scienter problem, the Commission adopted Rule 10b5-1¹³⁷ in 2000 along with Rule 10b5-2.¹³⁸ Rule 10b5-1 rejects both the use standard and possession standard, and instead adopts "aware" as the correct standard.¹³⁹ Thus, a person is trading "on the basis" of material, nonpublic information as long as the person was "aware" of said information at the time of the sale or purchase.¹⁴⁰ The rationale behind Rule 10b5-1 is that a person "who is aware of inside information at the

(stating that the defendant had a pre-existing plan to sell his shares prior to coming into possession of the material, nonpublic information, and therefore he had not violated Rule 10b-5).

131. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). The court defined scienter for the purposes of a Rule 10b-5 violation as "a mental state embracing intent to deceive, manipulate, or defraud." *Id.*

132. STEINBERG, *supra* note 130, at 691.

133. *United States v. Teicher*, 987 F.2d 112, 120 (2d Cir. 1993). The court specifically stated that "the government need not prove that the defendants purchased or sold securities because of the material nonpublic information that they knowingly possessed. It is sufficient if the government proves that the defendants purchased or sold securities while knowingly in possession of the material nonpublic information." *Id.* at 119.

134. *Adler*, 137 F.3d at 1337.

135. STEINBERG, *supra* note 130, at 691.

136. *United States v. Smith*, 155 F.3d 1051, 1067, 1069 (9th Cir. 1998). The court specifically refutes the analysis in *Teicher*, stating that "[d]espite the Second Circuit's thoughtful analysis, we believe that the weight of authority supports a 'use' requirement." *Id.* at 1067.

137. 17 C.F.R. § 240.10b5-1(b) (2008). The pertinent part of the rule states that "a purchase or sale of a security of an issuer is 'on the basis of' material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale." *Id.*

138. Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599 (Aug. 15, 2000).

139. 17 C.F.R. § 240.10b5-1(b); *see also* STEINBERG, *supra* note 130, at 691-92.

140. STEINBERG, *supra* note 130, at 691-92.

time of trading will have inevitably made use of such information.”¹⁴¹ Like Rule 10b5-2, the Commission felt that Rule 10b5-1 would both enhance the integrity of the securities markets and provide clarity and fairness for the market players.¹⁴²

Armed with its new weapon, the Commission encountered the perfect opportunity to gain judicial recognition of Rule 10b5-1 in a high profile insider trading action. The case involved Martha Stewart, quite possibly the most famous insider trader never to be convicted of insider trading.¹⁴³ The investigation of Ms. Stewart consisted of a criminal case brought by the United States Department of Justice and a civil action brought by the Commission.¹⁴⁴ While the Department of Justice declined to charge Ms. Stewart with a criminal insider trading violation of Rule 10b-5, the Commission included the charge in its civil Complaint.¹⁴⁵ The facts of Ms. Stewart’s case were ideal for pleading Rule 10b5-1. Ms. Stewart owned stock in ImClone, a pharmaceutical company, whose CEO had recently learned that the FDA was not going to approve ImClone’s new drug.¹⁴⁶ The CEO told his stockbroker to sell his ImClone stock, and the stockbroker in turn had an associate inform Ms. Stewart of the CEO’s sale.¹⁴⁷ Ms. Stewart sold her stock in ImClone before the FDA announcement, avoiding a minimal loss she would have otherwise incurred without the tip.¹⁴⁸

The relevant conduct occurred in 2001, after Rule 10b5-1 was enacted. The Rule was fair game for the Commission to plead in its Complaint against Ms. Stewart. It is fairly obvious from the facts that Ms. Stewart was aware of material, nonpublic information when she

141. *Id.*

142. *Id.* at 692.

143. J. Kelly Strader, *White Collar Crime and Punishment: Reflections on Michael, Martha, and Milberg Weiss*, 15 GEO. MASON L. REV. 45, 72-73 (2007) (noting that the United States Department of Justice declined to charge Martha Stewart for a criminal violation of insider trading).

144. *Id.* at 65-66.

145. *Id.* at 71. *But cf.* Douglas Rappaport et al., *When Is Insider Trading Subject To Criminal Prosecution?*, 240 N.Y. L.J. 10, 10 (2008) (suggesting that criminal prosecutions are more likely to occur when there are negative facts indicating a high level of guilt).

Given the virtually identical statutory framework, what determines if a case is pursued solely through civil enforcement or through criminal prosecution as well? Quite often the determination comes down to the defendant’s “story”—the facts and circumstances surrounding the alleged unlawful trading. The more egregious the story—the more aggravating facts associated with the alleged conduct—the greater the possibility of criminal charges.

Rappaport, *supra* at 10.

146. Strader, *supra* note 143, at 70-71.

147. *Id.* at 71.

148. To highlight the absurdity of Ms. Stewart’s actions, the amount of loss she avoided was \$45,673, not a great sum of money for a multi-millionaire. *Id.*

made her trades. The Commission, however, decided to once again plead the possession standard in their Complaint.¹⁴⁹ This is the same possession standard that was explicitly rejected by the Ninth and Eleventh Circuits, and was purposefully abandoned by the SEC when they passed Rule 10b5-1. Clearly, the correct standard to use in the Complaint was awareness, but the Commission failed to take advantage of the opportunity.¹⁵⁰

Instead, the Commission pled the old possession standard and ignored Rule 10b5-1. To highlight the incomprehensible nature of this omission, even commentators sympathetic to Ms. Stewart have noted that Rule 10b5-1 was the correct standard to use for scienter.¹⁵¹ Ultimately, the Commission never had to pay for its careless mistake¹⁵² in ignoring Rule 10b5-1, because Ms. Stewart settled the civil charges and the case never went to trial.¹⁵³ Nonetheless, the treatment of Rule 10b5-1 in Ms. Stewart's case highlights a pattern that the Commission has repeated with Rule 10b5-2.

149. The relevant part of the Complaint alleges that:

30. While in possession of the information that the Waksals were selling or attempting to sell their ImClone stock, Stewart sold 3,928 shares of ImClone stock on December 27, 2001.

31. The information that Stewart possessed on December 27, 2001, that the Waksals were selling or attempting to sell their ImClone stock, was material and nonpublic. Complaint at 30-31, SEC v. Stewart, No. 03-CV-4070 (S.D.N.Y. June 4, 2003).

150. *Id.*

151. Langevoort writes that:

As Rule 10b5-1 shows, the SEC prefers a simplified state of mind inquiry, and could claim that even if the foregoing were true (1) Stewart still had one piece of information that the rest of the world did not, received from a private source in arguable breach of fiduciary duty; (2) under these circumstances, she recklessly failed to ascertain the state of public knowledge before selling; and (3) that information does not become public until it is *fully* internalized by the market. . . . And even if she did act with scienter because the law (i.e., Rule 10b5-1) is construed to make scienter easier for the SEC or prosecutors to prove in the insider trading context, we see a consequence that might be somewhat troubling.

Donald C. Langevoort, *Reflections on Scienter (and the Securities Fraud Case Against Martha Stewart that Never Happened)*, 10 LEWIS & CLARK L. REV. 1, 14 (2006). Langevoort overlooks the fact that the SEC did not plead Rule 10b5-1 in the Complaint, and assumes that they did.

152. Not only was it a careless mistake to ignore Rule 10b5-1, but it was arguably more careless to utilize the possession standard. The possession standard was less likely to be successful, as courts had embraced the use standard in recent years. The aware standard of Rule 10b5-1 requires more than possession, but less than use for scienter. Therefore, utilizing the possession standard made little sense in light of the recent trend in the case law. See Swanson, *supra* note 18, at 190-91.

153. Stewart, Litigation Release No. 19,794 (Aug. 7, 2006).

B. The Commission Rolls the Dice

Since 2000, the Commission has brought many insider trading actions involving the duty problem. The SEC handles the cases in one of two ways: either Rule 10b5-2 is utilized in the complaint, or Rule 10b5-2 is ignored and the Commission merely alleges that the relationship in question creates a fiduciary duty. When the latter method is followed, the results vary greatly for the Commission. In some instances, the Commission wins despite the omission. The cumulative result of choosing the latter method, however, is the formation of an unpredictable and incoherent body of case law. This runs counter to the purpose of Rule 10b5-2, which was enacted to ensure fairness and clarity.¹⁵⁴ Though a failure to use the Rule does not mean the SEC will lose the case, winning individual cases is not the goal of the Program.¹⁵⁵

A good example of the SEC “rolling the dice” with Rule 10b5-2 is the SEC civil action brought against James D. Zeglis.¹⁵⁶ Zeglis was charged with misappropriating material, nonpublic information from his brother, a member of the board of directors of Georgia-Pacific Corp., concerning an impending takeover by Koch Industries, Inc.¹⁵⁷ Zeglis tipped several of his friends with this information, and they traded on the information to their profit, providing Zeglis with kickbacks from their gains.¹⁵⁸ While Zeglis clearly was a tipper who received a benefit for his tip, the Commission still had to prove that he had a fiduciary duty to the source of his information.¹⁵⁹

The complaint against Zeglis darts around the fiduciary duty issue and merely concludes that the defendant should have known that the information was confidential.¹⁶⁰ This tactic does nothing to prove that

154. Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599 (Aug. 15, 2000).

155. The SEC’s website states that “[b]ecause insider trading undermines investor confidence in the fairness and integrity of the securities markets, the SEC has treated the detection and prosecution of insider trading violations as one of its enforcement priorities.” Insider Trading, <http://www.sec.gov/answers/insider.htm> (last visited July 26, 2009).

156. Zeglis, Litigation Release No. 20,852 (Jan. 13, 2009).

157. *Id.*

158. *Id.*

159. *United States v. O’Hagan*, 521 U.S. 642, 652 (1997).

160. Two paragraphs of the Complaint provide the SEC’s proof that Zeglis misappropriated material, nonpublic information from his brother:

27. Any information concerning a corporate acquisition provided to Zeglis by his brother, would have been accompanied by a warning that the information was proprietary, sensitive and not to be repeated.

30. Defendant Zeglis, who is a practicing attorney, knew or should have known that information he received regarding Georgia-Pacific’s consolidation into Koch was proprietary, sensitive and not information that should be repeated or acted on. Defendant Zeglis fully understood the importance of keeping business information confidential.

the defendant owed a fiduciary duty to his brother (the source of his information). The complaint states that Zeglis would have been warned that any information he received was confidential, but fails to state how this warning creates a fiduciary duty.¹⁶¹ The case against Zeglis was clearly an instance that called for Rule 10b5-2, but the Commission failed to use it.¹⁶²

The SEC was also “rolling the dice” in *SEC v. Kornman*,¹⁶³ where the defendant was an attorney who provided tax and estate planning services.¹⁶⁴ After a meeting with two potential clients, he traded on the confidential information gained from this meeting to his profit.¹⁶⁵ The defendant provided each client with a written memorandum after the meeting that contained a confidentiality clause meant to protect each client’s interests.¹⁶⁶ As in *Zeglis*, the Commission needed to prove that the defendant breached a fiduciary duty to the source of his information in order to prove liability under the misappropriation theory.¹⁶⁷ Unfortunately, the Commission forgot the lesson learned in *Kim* (in which the court held that a confidentiality agreement alone did not create a fiduciary duty)¹⁶⁸ and failed to plead Rule 10b5-2 to provide the link between the confidentiality agreement and the creation of a fiduciary duty.¹⁶⁹

The logical conclusion is that the SEC’s omission in the *Zeglis* and *Kornman* cases would result in a victory for both defendants. Surprisingly, the Commission was victorious on both accounts, and the defendants were forced to pay disgorgement penalties.¹⁷⁰ Further, in the *Kornman* case, the court injected Rule 10b5-2 into the analysis, and held

Complaint at 27, 30, *SEC v. Zeglis*, No. 08 Civ. 5259 (N.D. Ill. Sept. 16, 2008).

161. *Id.*

162. The complaint makes no mention of Rule 10b5-2. *See id.*

163. 391 F. Supp. 2d 477, 479 (N.D. Tex. 2005).

164. *Id.* at 479.

165. *Id.* at 480-81.

166. *Id.* at 479-80.

167. *Unites States v. O’Hagan*, 521 U.S. 642, 652 (1997).

168. *United States v. Kim*, 184 F. Supp. 2d 1006, 1015 (N.D. Cal. 2002).

169. The Complaint details the breach of fiduciary duty as:

46. Kornman purchased and sold securities of issuers Minimed [sic] and Hollywood, in breach of a duty of trust or confidence that he owed directly, indirectly, or derivatively, to the sources of the material nonpublic information – the MiniMed and Hollywood executives. Kornman breached duties of trust and confidence established by agreement, by history, pattern, or practice of sharing confidences, and by the sensitive nature of the professional services discussed.

Complaint at 46, *SEC v. Kornman*, 391 F. Supp. 2d 477 (N.D. Tex. 2005) (No. 304 Civ 1803-L).

170. *Zeglis*, Litigation Release No. 20,852 (Jan. 13, 2009). The final judgment was ordered against the defendant’s estate, as the defendant had passed away prior to the conclusion of his case. *Id.* The *Kornman* court had previously denied the defendant’s motion to dismiss. *Kornman*, 391 F. Supp. 2d at 495.

that the confidentiality agreement created a fiduciary duty pursuant to the Rule.¹⁷¹ The court in *Kornman* made the logical step to utilize Rule 10b5-2. The cynical observer might question where the problem lies in this scenario, since the SEC by all accounts “won” both cases and the Rule was cited in the *Kornman* opinion. The answer is simply that cases such as *Zeglis* and *Kornman* do nothing to promote the stated goal of the Program: fairness. Fairness is achieved with a concise, predictable, and firm body of case law that provides clear guidance to the market players.¹⁷² Fairness is not achieved by “rolling the dice” and counting on the courts to do the heavy lifting.

C. Rule 10b5-2 Proves Successful When Utilized

The Commission could not be considered inconsistent if they never used Rule 10b5-2 at all. The Rule has provided successful results in some duty problem cases. Nonetheless, the problem that the Commission faces when it fails to plead the Rule continues to exist. Cases resulting in a victory for the Commission are hollow, as the goal of fairness is still not met, and the case law becomes further disjointed.

*SEC v. Nothern*¹⁷³ exemplifies the successful usage of Rule 10b5-2, in the context of a summary judgment motion. In *Nothern*, the defendant was a mutual funds manager at Massachusetts Financial Services Company (“MFS”).¹⁷⁴ Davis, a consultant who specialized in providing financial companies with reports on political and financial events from Washington D.C., was hired by MFS to provide Nothern with these reports.¹⁷⁵ On October 31, 2001 at 9:00 a.m., Davis attended a United States Department of Treasury meeting in which he learned confidential information about thirty-year bonds.¹⁷⁶ Davis, and all others in attendance, was told that he could not reveal this information until 10:00 a.m., when the Treasury would make it public.¹⁷⁷ At 9:38 a.m., Davis called Nothern, informed him of this confidential information, and Nothern then traded on the information for a profit.¹⁷⁸ The SEC charged

171. *Kornman*, 391 F. Supp. 2d at 489-90. “The court’s determination that the complaint has sufficiently alleged a fiduciary-like relationship to withstand Defendant’s motion to dismiss is bolstered by the SEC’s statements in adopting Rule 10b5-2.” *Id.* at 489.

172. See Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599 (Aug. 15, 2000) (stating that Rules 10b5-1 and 10b5-2 were enacted to clarify ambiguities in the insider trading case law).

173. *SEC v. Nothern*, No. 05-10983-NMG, 2009 WL 467535 (D. Mass. Feb. 20, 2009).

174. *Id.* at *1.

175. *Id.*

176. *Id.*

177. *Id.*

178. *Id.*

that Davis tipped Nothern, and that Davis had a fiduciary duty to the Treasury not to divulge the confidential information.¹⁷⁹

The Commission pled Rule 10b5-2 in its Complaint to prove that the relationship between Davis and the Treasury created a fiduciary duty.¹⁸⁰ The *Nothern* court ruled that since Davis had admitted agreeing to keep the Treasury information in confidence, under Rule 10b5-2 the relationship could create a fiduciary duty.¹⁸¹ Interestingly, Nothern attacked the validity of the Rule, claiming that it was only meant to apply to non-business relationships.¹⁸² The court dismissed this argument and held that “[n]either the SEC release describing the then-proposed Rule 10b5-2 nor the text of the Rule itself indicates, however, that its scope is limited to only non-business relationships.”¹⁸³ Ultimately, the Commission pled Rule 10b5-2, the court correctly applied the Rule, and the SEC won the summary judgment motion.¹⁸⁴

The Commission has also been successful using Rule 10b5-2 in cases that have settled with an admission of guilt and the defendant’s agreement to disgorge the profits made from trading. The Commission’s “win” is less important than the effective use of Rule 10b5-2 to properly charge the alleged wrongdoers. A good example is *SEC v. Willey*.¹⁸⁵ The defendant was a senior manager at Capital One Financial Corporation, and had misappropriated information provided by an examiner from the Federal Reserve Board of Governors concerning the financial health of Capital One.¹⁸⁶ With this information, the defendant exercised his stock options before Capital One found out about the report (which would have led them to bar the defendant from exercising his options) and he

179. *Id.*

180. The Rule is pled as follows:

45. Rule 10b5-2(b)(1) . . . provides that a duty of trust and confidence exists for purposes of Section 10(b) of the Exchange Act and Rule 10b5 thereunder “whenever a person agrees to maintain information in confidence.”

46. As set forth above, in 1994, Davis agreed and promised, in a face-to-face meeting with a Treasury official, that if he were permitted to attend Treasury refunding press conferences, in return he would obey and abide by all Treasury embargos on information disclosed at such conferences.

47. Davis violated the duty of trust and confidence he owed to Treasury by communicating the material nonpublic information disclosed at the October 31, 2001 refunding press conference to Nothern prior to the expiration of the Treasury-imposed embargo on the information.

Complaint at 45-47, *SEC v. Nothern*, 2009 WL 467535 (D. Mass. 2005) (No. 05 Civ. 10983).

181. *Nothern*, 2009 WL 467535, at *5.

182. *Id.* at *6.

183. *Id.*

184. *Id.* at *8.

185. *Willey*, Litigation Release No. 19,918 (Nov. 20, 2006).

186. *Id.*

made a substantial profit.¹⁸⁷ The Commission used Rule 10b5-2 to charge the defendant with a breach of a fiduciary duty to Capital One by his misappropriation of the information from the examiner.¹⁸⁸ Ultimately, the defendant settled the charges and disgorged the profits he made.¹⁸⁹

D. The Courts Add to the Confusion

Rule 10b5-2's lack of success is not solely the Commission's fault. The courts share in the blame. The best example of the courts' contribution to the duty problem occurred in 2006, when the Commission brought what appeared to be a clear case against an outsider not unlike the defendant in *O'Hagan*.¹⁹⁰ In *SEC v. Talbot*, the defendant was an attorney and member of the Board of Directors for Fidelity, a national title insurance company.¹⁹¹ Fidelity had a partial ownership interest in LendingTree, an online realty and lending services exchange, which had been approached for a takeover by USA Interactive.¹⁹² Fidelity's Board of Directors was notified of this information, since they had to agree to the proposed share price for the takeover to be legal.¹⁹³ Using this information, the defendant purchased LendingTree stock and profited when the merger was announced.¹⁹⁴ Importantly, none of the other Board members traded on this information, and the court noted that it was "undisputed" that this information was "nonpublic and confidential."¹⁹⁵

Despite these damaging facts, the court granted the defendant summary judgment.¹⁹⁶ The irony of this result did not go unnoticed.¹⁹⁷

187. *Id.*

188. The relevant portion of the Complaint is as follows:

42. By reason of the conduct described above, Willey violated Section 10(b) of the Exchange Act [15 U.S.C. § 78j(b)] and Rule 10b-5 thereunder [17 C.F.R. § 240.10b-5], as further defined by Rules 10b5-1 and 10b5-2 [17 C.F.R. §§ 240.10b5-1 and 240.10b5-2].

Complaint at 42, *SEC v. Willey*, No. 04 Civ. 01243 (D.D.C. July 24, 2004).

189. Willey, Litigation Release No. 19,918 (Nov. 20, 2006).

190. Compare *SEC v. Talbot*, 430 F. Supp. 2d 1029, 1032 (C.D. Cal. 2006) with *United States v. O'Hagan*, 521 U.S. 642, 647-48 (1997) (illustrating scenarios involving individuals using positions of confidence in order to misappropriate the material, nonpublic information upon which they traded.).

191. *Talbot*, 430 F. Supp. 2d at 1032.

192. *Id.* at 1032-33.

193. *Id.* at 1033.

194. *Id.* at 1034-35.

195. *Id.* at 1035-36.

196. *Id.* at 1064.

197. Colesanti notes that in *Talbot*:

While the ruling was puzzling, it became clear that the court's misappropriation theory analysis involved a misapplication of Rule 10b5-2.¹⁹⁸ By framing the issue in terms of whether or not there was a fiduciary duty between LendingTree and Fidelity, the court found that Rule 10b5-2 did not apply since there was no history or practice of sharing confidences between the two companies.¹⁹⁹ A closer look at the SEC's argument in the case reveals that it tactically did not plead Rule 10b5-2 because it does not prove that there was a relationship of trust or confidence between LendingTree and Fidelity.²⁰⁰

On appeal, the Ninth Circuit remedied the situation by reversing the grant of summary judgment and holding that the defendant could be held liable under the misappropriation theory based on the facts.²⁰¹ The court correctly concluded that a fiduciary duty merely needs to be shown to the source (Fidelity), and not the original source (LendingTree), of the inside information (the basic tenet of *O'Hagan*).²⁰² As a board director, the defendant obviously owed a fiduciary duty to Fidelity, and the misappropriation theory analysis is simple once the mistake by the district court is corrected.²⁰³ Most importantly, the Ninth Circuit recognized, at least implicitly, that Rule 10b5-2 was incorrectly injected into the analysis of the case.²⁰⁴ The Commission once again declined to

The irony here should not be glossed over: The SEC, which had commenced its insider trading enforcement program by focusing on those in attendance of a closed board meeting, after working so long and hard to expand the scope of that program to include those outside the boardroom, lost an insider trading case against someone in the boardroom. At the very least, the Program's hard fought victory in *O'Hagan* has become suspect.

Colesanti, *supra* note 3, at 558; see also Madden, *supra* note 8, at 74-75. Madden notes that "[u]nder . . . *Talbot*, it appears that Rule 10b5-2 may be entirely superfluous. Enough case law may exist defining a relationship of trust or confidence without it." *Id.*

198. The court opined in a footnote that:

The SEC cites Rule 10b5-2 as the standard for determining when "a person has a duty of trust or confidence for purposes of the 'misappropriation' theory of insider trading under Section 10(b) of the Act and Rule 10b-5." . . . Rule 10b5-2 was not intended to apply to business relationships. Because this case deals with purely business relationships, the court applies *Kim*'s three-part test instead of the standard articulated in Rule 10b5-2. Even were this test applied, however, the result would not change, as the SEC has adduced no evidence of an express agreement by Fidelity to maintain the acquisition information confidentially, nor a "history, pattern or practice of sharing confidences" absent such an agreement.

Talbot, 430 F. Supp. 2d at 1061 n.91 (citation omitted).

199. See *id.* at 1061 & n. 91, 1062, 1064.

200. See generally Complaint, SEC v. Talbot, 430 F. Supp. 2d 1029, (C.D. Cal. 2004) (No. CV-04-4556) (making no mention of Rule 10b5-2).

201. SEC v. Talbot, 530 F.3d 1085, 1098 (9th Cir. 2008).

202. *Id.* at 1093.

203. *Id.* at 1097.

204. The court opined that:

plead the Rule, and did not contest the district court's analysis of it in their appellate brief.²⁰⁵

The *Talbot* cases reveal several important concerns. First, the patchwork application of Rule 10b5-2 has created an anomalous result. Instead of the Rule engendering clarity and fairness, it has furthered the confusion surrounding the creation of a fiduciary duty. Second, Rule 10b5-2 may be too vague to accomplish its stated goals. While the Commission left the first prong of Rule 10b5-2 vague,²⁰⁶ it is clear that after *Talbot* it may be too vague, since its applicability is unclear when the relationship is business in nature. Ultimately, *Talbot* embodies the biggest concern with the duty problem. The relevant conduct in *Talbot* occurred in 2003, and the SEC brought charges in 2004.²⁰⁷ The case reversing the grant of summary judgment occurred in 2008, and remanded the issue for a new trial.²⁰⁸ Even if the defendant were to settle the case today, the litigation in *Talbot* will have lasted at least five years.²⁰⁹ Not only is this a waste of the SEC's time,²¹⁰ but it keeps precedent in suspense and creates fractures in the case law while other cases are pending.

Since its passage in 2000, Rule 10b5-2 has been inconsistently applied, with the end result often unpredictable. The patchwork application of Rule 10b5-2 has done nothing to further the goals sought to be achieved with the Rule.²¹¹ What can be done to revitalize the

It is unclear from the record before us whether Fidelity and, by extension, Talbot, owed a fiduciary duty arising from a relationship of trust and confidence to LendingTree. The district court determined that the SEC had not carried its burden of proving that such a duty existed. The SEC has not appealed that holding, arguing that Talbot's relationship to Fidelity alone is sufficient to sustain liability.

Id. at 1092 n.2.

205. See Brief for Plaintiff-Appellant at 3, *SEC v. Talbot*, 530 F.3d 1085 (9th Cir. 2006) (No.06-55561) (making no mention of Rule 10b5-2 or responding to the district court's analysis of the Rule).

206. 17 C.F.R. § 240.10b5-2(b)(1) (2008).

207. *Talbot*, 530 F.3d at 1088-89.

208. *Id.* at 1098.

209. Talbot, Litigation Release No. 21,004 (April 16, 2009) (reporting that the defendant in *Talbot* subsequently entered into a settlement with the SEC after the ruling by the Ninth Circuit).

210. The defendant in *Talbot* only profited by \$67,881.20. *Talbot*, 530 F.3d at 1089. This figure does not seem worth the cost in time and expense that the SEC must expend to bring an enforcement action.

211. The Commission wrote that:

Two principle benefits are likely to result from this rule. First, the rule will provide greater clarity and certainty to the law on the question of when a family relationship will create a duty of trust or confidence. Second, the rule will address an anomaly in current law under which a family member receiving material nonpublic information may exploit it without violating the prohibition against insider trading. By addressing this potential gap in the law, the rule will enhance investor confidence in the integrity of the market.

Commission and turn the patchwork application into firm and predictable case law?

IV. THE DUTY PROBLEM TODAY AND PROPOSALS FOR A SOLUTION

A. *The Lingering Duty Problem*

The duty problem remains an issue that the Commission, courts, and market players deal with today. Two recent insider trading cases that have been filed by the SEC prove the continuing struggle with this unfortunate confusion. The first case is *SEC v. Devlin*, which involves a very sophisticated and complicated tipper/tippee ring of investors, alleged to have generated approximately \$4.8 million in illicit profits.²¹² The key for the Commission is proving that the tipper, Devlin, has both breached a fiduciary duty to the source of his information and received a benefit from his tippees.²¹³ Devlin allegedly received his inside information from his wife, who worked at an international public relations firm and was privy to information about a variety of mergers.²¹⁴ Armed with this valuable knowledge, Devlin traded on it to his profit, and proceeded to set up an elaborate ring of tippees with whom the inside information was exchanged for money, gifts, and favors, among other things.²¹⁵ In a comic twist, the success of the group led many members to dub Devlin's wife with the moniker "golden goose."²¹⁶

The duty problem is proving that Devlin was in a relationship of trust or confidence with his wife, the source of the inside information. This is not only important for convicting Devlin, but for convicting each and every one of the tippees, as their liability is contingent upon Devlin breaching a fiduciary duty.²¹⁷ This is clearly the type of problem that Rule 10b5-2 was enacted to resolve. The SEC should allege that, pursuant to Rule 10b5-2, Devlin and his wife were in a relationship of trust and confidence based upon some sort of agreement or

Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599 (Aug. 15, 2000).

212. Devlin, Litigation Release No. 20,831 (Dec. 18, 2008).

213. *Dirks v. SEC*, 463 U.S. 646, 662 (1983); *see also* *United States v. O'Hagan*, 521 U.S. 642, 652 (1997). The SEC needs to prove that Devlin misappropriated the information from his wife pursuant to *O'Hagan*, and that his tippees provided him with a personal benefit pursuant to *Dirks* in order for all of them to be liable.

214. Devlin, Litigation Release No. 20,831 (Dec. 18, 2008).

215. *Id.*

216. *Id.*

217. *Dirks*, 463 U.S. at 660 (stating that absent a breach by the tipper, there can be no derivative liability that flows to the tippee).

acknowledgment that the information should remain confidential.²¹⁸ In the Complaint, the Commission instead assumed that since they were married, they were in a relationship of trust and confidence, and did not mention Rule 10b5-2.²¹⁹ According to the Commission, the mere fact that Devlin knew or should have known his wife had a duty to keep the information confidential is sufficient to prove the existence of a fiduciary duty.²²⁰

The second case has the potential to be a more infamous insider trading case than Martha Stewart's. In *SEC v. Cuban*, the controversial owner of the Dallas Mavericks and Internet start-up billionaire Mark Cuban is alleged to have engaged in insider trading.²²¹ The facts are fairly straight forward. Cuban owned stock in Mamma.com Inc., a publicly traded web-based search engine, which was contemplating a PIPE (private investment in public equity) financing to raise more capital for the company.²²² The drawback to this particular PIPE financing is that Mamma.com planned to conduct it at a discount to the current market price of its stock.²²³ Once publicly revealed, the issuance

218. This quote from a news article on the *Devlin* case insinuates that Mr. Devlin was, at least according to his wife, supposed to have kept the information confidential:

"Nina Devlin is devoted to her clients and colleagues and has always sought to uphold the highest standards of professionalism in her work," [her attorney] Mr. Benjamin said. "She was completely unaware that confidential information about her job was being used as the basis for securities trading. She is devastated by this terrible situation."

Mark Hamblett, *Associate Charged With Insider Trading*, 240 N.Y. L.J. 119 (2008).

219. The relevant portions of the Complaint are as follows:

29. Devlin's wife had a duty to keep all nonpublic information concerning her clients confidential.

30. Devlin and his wife were married in 2003.

31. At all relevant times, Devlin was a registered representative with Lehman, where he had been employed since at least 2000. As a condition of his employment with Lehman, Devlin certified that he would not trade on his own behalf or on behalf of others if he knew or had reason to believe that he possessed material nonpublic information.

32. Devlin knew or was reckless in not knowing that his wife owed her employer and her employer's clients a fiduciary duty or other duty of trust or confidence to keep confidential and not disclose, personally use, or misappropriate the material nonpublic information that she learned about her clients in the course of her work. Devlin knew or was reckless in not knowing that he owed his wife a duty of trust or confidence not to disclose, personally use, or misappropriate confidential information that he learned from her.

33. During the course of his marriage, Devlin misappropriated material nonpublic information concerning at least twelve upcoming corporate acquisitions or attempted acquisitions involving his wife's clients.

Complaint at 29-33, *SEC v. Devlin*, No. 08 Civ. 11001 (S.D.N.Y. Dec. 18, 2008). Rule 10b5-2 is not mentioned in the Complaint. *Id.*

220. *See id.*

221. Cuban, Litigation Release No. 20,810 (Nov. 17, 2008).

222. *Id.*

223. *Id.*

of the PIPE would result in a loss in the value of the company's stock, and expose Cuban to losses amounting to somewhere near \$750,000.²²⁴

The next two facts, if true as they are alleged, are critical for the Commission's case. First, the CEO of Mamma.com called up Cuban to make him aware of the PIPE financing; but before informing Cuban, the CEO had Cuban agree to maintain the information in confidence.²²⁵ Second, in breach of this agreement, Cuban called his broker and sold his entire interest in Mamma.com before the news of the PIPE financing became public.²²⁶ Essentially, *Cuban* boils down to whether or not Cuban agreed to keep the information confidential. Under Rule 10b5-2, if Cuban agreed to do so, he would be in a relationship of trust and confidence with Mamma.com, and therefore in breach of a fiduciary duty by misappropriating confidential information to avoid losses. As with *Devlin*, Rule 10b5-2 was not pled in the Complaint, and the Commission was satisfied with merely repeating the allegations of the Mamma.com CEO.²²⁷

The Commission will probably win both *Devlin* and *Cuban*. The allegations made by the SEC in each case, if true, are very damaging for the defendants. However, the duty problem in both cases will present hurdles for the Commission, especially if either case proceeds to trial. Nonetheless, it is important to highlight several aspects of these pending cases. The duty problem is pervasive and continues to hinder the Commission in current misappropriation theory actions. Rule 10b5-2 is not being used to help the Program reach outsiders who engage in improper trading. While *Devlin* and *Cuban* present particularly unlikable defendants, by failing to use Rule 10b5-2, the Commission could be creating unnecessary litigation as it did in *Talbot*. A loss in either case would further complicate the existing case law. Ultimately, fairness is not being realized. Fairness and clarity are not achieved by continuing to ignore Rule 10b5-2. Fairness is the ultimate goal, and as *Devlin* and *Cuban* show, there is still a long way to go.

224. *Id.*

225. *Id.*

226. *Id.*

227. The relevant portion of the Complaint reads as follows:

14. The CEO prefaced the call by informing Cuban that he had confidential information to convey to him, and Cuban agreed that he would keep whatever information the CEO intended to share with him confidential. The CEO, in reliance on Cuban's agreement to keep the information confidential, proceeded to tell Cuban about the PIPE offering. Cuban became very upset and angry during the conversation, and said, among other things, that he did not like PIPEs because they dilute the existing shareholders. At the end of the call, Cuban told the CEO "Well, now I'm screwed. I can't sell."

Complaint at 14, SEC v. Cuban, No. 3-08-CV-2050-D (N.D. Tex. Nov. 17, 2008). No mention of Rule 10b5-2 is made in the Complaint. *See id.* at 30, 33.

B. *Proposed Solutions to Solve the Duty Problem*

1. Pass a New Rule

The current Rule 10b5-2 has three prongs, each dealing with a different aspect of the relationships meant to be covered by the Rule.²²⁸ Since the SEC has the ability to enact rules pursuant to its authority under the Exchange Act, it can always pass a new rule.²²⁹ Thus, instead of the current three pronged approach, which is both vague and restrictive, the Commission would be better served to pass a new rule, characterized by a more useful and expansive five pronged approach. The rule would read as follows:

(b) Enumerated “Duties of Trust or Confidence.” For purposes of this Rule 10b5-2, a “duty of trust or confidence” exists in the following circumstances, and is governed by the following provisions:

(1) A person who agrees to maintain information in confidence in any kind of personal, private, or business relationship is in a relationship of trust and confidence;

(2) An agreement to maintain information in confidence does not require an explicit affirmation of confidentiality, and may be determined on the basis of whether a reasonable person would believe that the information was meant to be kept in confidence;

(3) A history, pattern, or practice of sharing information is sufficient to establish a relationship of trust and confidence;

(4) A person who receives or obtains material, nonpublic information from his or her spouse, parent, child, sibling, or relative is in a relationship of trust and confidence; and

(5) The burden of proof is on the defendant to disprove that the relationship in question creates a fiduciary duty.

The new rule would be far broader in its application than Rule 10b5-2, and may be too broad for the courts to accept as within the Commission’s authority. Nonetheless, it would be a vast improvement because the two main goals of Rule 10b5-2 (fairness and clarity) are difficult to realize without expanding the boundaries of the present Rule. The new rule would provide the Commission with the proper weapon to create a firm and predictable body of case law, because it would encompass all outsider trading.²³⁰ Ultimately, while the new rule would

228. 17 C.F.R. § 240.10b5-2 (2008).

229. 15 U.S.C. § 78j(b) (2008); *see also* Steinbuch, *supra* note 21, at 572 (discussing the Commission’s power to enact Rules pursuant to its authority under the Securities Exchange Act).

230. *See* Madden, *supra* note 8, at 75 (noting that while the Commission states that it wishes to encompass all outsider trading, Rule 10b5-2, as it currently stands, is not capable of achieving this goal).

probably receive a poor reception, such potential criticism is dwarfed by the goals of the Program.²³¹ The proposed rule would accomplish these goals.

2. Consistently Use the Present Rule

The Commission must internally mandate that Rule 10b5-2, as it currently exists, is pled every time it is applicable. This would be an effective solution because the inconsistent application of the Rule continues to plague the Commission when it charges investors under the misappropriation theory of insider trading.²³² Through consistently pleading the Rule, a uniform body of case law would emerge. Many of the goals behind the passage of Rule 10b5-2 would be realized because the courts would have to settle one way or the other on the duty problem. With a wealth of court interpretation and application, investors would receive greater clarity on which relationships satisfy the misappropriation theory. The goal of fairness would be achieved.

Implicit in this second proposal is the assumption that Rule 10b5-2 in its present form is sufficient to solve the duty problem.²³³ In a frustrating bit of circular logic, this cannot be confirmed unless the Rule is consistently pled and precedent is established by the courts. Another drawback is that this proposal is at risk for two potential criticisms. Coordination amongst the SEC is difficult. The SEC is comprised of eleven regional offices, with the headquarters located in Washington, D.C.²³⁴ Despite this structural setback, the Commission has coordinated countless multi-office investigations and certainly has the resources to effect such a proposal.

The second potential criticism poses a much greater problem. The courts could define the scope of Rule 10b5-2 so narrowly that the duty

231. See *supra* note 4.

232. See Goodson, Litigation Release No. 17,349 (Jan. 31, 2002) (reporting that all of the *Goodson* defendants were acquitted of violating Rule 10b-5). The *Goodson* case highlights the importance of Rule 10b5-2, and rebuts the arguments of critics who claim that Rule 10b5-2 is redundant and unnecessary, because although Rule 10b5-2 was not in effect at the time, the court used the reasoning for the Rule to bolster the Commission's case. SEC v. Goodson, No. 99CV2133, 2001 WL 819431, at *3 (N.D. Ga. Mar. 6, 2001).

233. See Steinbuch, *supra* note 21, at 596-98 (discussing that computer hackers of financial information should be held liable for insider trading under Rule 10b-5 and alluding that Rule 10b5-2 would aid in this challenge); see also Leib, *supra* note 21, at 693-94 (asserting that friendship should be a fiduciary duty, even though friendship is not explicitly mentioned in 10b5-2); cf. Ray J. Grzebielski, *Why Martha Stewart Did Not Violate Rule 10b-5: On Tipping, Piggybacking, Front-Running, and the Fiduciary Duties of Securities Brokers*, 40 AKRON L. REV. 55, 80-81 (2007) (discussing that it is questionable whether Rule 10b5-2 applies in the situation where someone trades based on a stockbroker's recommendation, but is unaware whether the stockbroker violated his confidentiality agreement in recommending the trade based on another customer's conduct).

234. SEC Addresses, <http://www.sec.gov/contact/addresses.htm> (last visited July 26, 2009).

problem remains. By consistently pleading the Rule as it stands, this scenario could occur. While unlikely, it would be a serious detriment to the Program, as the Commission would be forced to go back to the drawing board with a major failure on its hands. Even in this undesirable scenario, at the very least the goal of fairness and clarity in the law would be met, albeit not in the favor of the Commission's view of the duty problem. Thus, while this solution is not perfect, if implemented it would provide an improvement on the current state of the duty problem.

V. CONCLUSION

The Commission passed Rule 10b5-2 with the aim of providing fairness and clarity to the muddled case law governing the fiduciary duty requirement of the misappropriation theory. When the Rule was initially adopted, there were fears that the SEC would use the Rule to abuse its authority and pursue investors who were not traditionally found to be in violation of Rule 10b-5.²³⁵ Instead, the Rule has fallen into obscurity and become an afterthought of the SEC, courts, and market players. Such a precedent is dangerous for the SEC: passing rules that are ignored and under-utilized may lead to the courts and investors taking the Commission less seriously. The SEC performs a very important function in our financial markets, and especially in light of the current economic crisis, is vital to the financial health of the United States. The Commission can ill afford to perform its duties in a disjointed fashion.

The SEC needs to account for its misdeeds. Rule 10b5-2 is not getting the job done, and the duty problem remains a hurdle in misappropriation theory cases. While the Commission is not solely to blame, it is their burden to overcome the duty problem. The SEC is the expert, and the courts are often relying on it to function as such. When the Commission fails in this role, it does a disservice to the constituency it was created to protect. The results of the last nine years suggest that new tactics warrant consideration by the SEC. Ultimately, the power to resolve the duty problem and revitalize the Program rests in the Commission's hands.

*Michael G. Capeci**

235. See Letter from Stanley Keller, Chair, Am. Bar Ass'n & Steven W. Hansen, Co-Chair, Am. Bar Ass'n, to Jonathan G. Katz, Sec'y, SEC (May 8, 2000), *available at* <http://www.sec.gov/rules/proposed/s73199/keller1.htm> (expressing concerns that the erosion of privacy rights under Rule 10b5-2 could have harmful effects on the investing public).

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