Friends, Family, Fiduciaries: Personal Relationships as a Basis for Insider Trading Violations

Ray J. Grzebielski

Follow this and additional works at: https://scholarship.law.edu/lawreview

Recommended Citation

Available at: https://scholarship.law.edu/lawreview/vol51/iss2/4

This Article is brought to you for free and open access by CUA Law Scholarship Repository. It has been accepted for inclusion in Catholic University Law Review by an authorized editor of CUA Law Scholarship Repository. For more information, please contact edinger@law.edu.
FRIENDS, FAMILY, FIDUCIARIES: PERSONAL RELATIONSHIPS AS A BASIS FOR INSIDER TRADING VIOLATIONS

Ray J. Grzebielski

From 1980, the date of the United States Supreme Court opinion in *Chiarella v. United States*,¹ to the Court’s opinion in *United States v. O’Hagan*² seventeen years later, the scope of the Securities and Exchange Commission’s (SEC) prohibition against trading in securities with material, nonpublic information³ under Rule 10b-5,⁴ remained

¹ Associate Professor, DePaul University College of Law. B.A. 1970, Northwestern University; M.B.A. 1981, University of Chicago; J.D. 1973, Northwestern University; LL.M. 1978, Georgetown University. Member of the Illinois Bar. The author is greatly indebted to Helena Kapjon for her secretarial assistance on this article.


⁴ Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988) (stating that the Supreme Court adopted a standard of materiality such that in a proxy solicitation context, “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote”). The Court also stated that “there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.” Id. at 231-32.

⁵ 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.


The SEC promulgated Rule 10b-5 pursuant to authority granted to it under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78-78mm (1994), which 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 . . . . To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such *rules and regulations as the Commission*
unsettled. The Supreme Court clarified how courts should apply Rule 10b-5 against insider trading in *O'Hagan.* The Court held that, in order to violate Rule 10b-5 for insider trading, an individual must breach a duty within a pre-existing relationship of trust or confidence. This relationship can be between the person abusing the information and either a party to a securities transaction or a party from whom material, nonpublic information was misappropriated. Anyone receiving information from a party breaching either duty violates Rule 10b-5 if the information is received to further an improper purpose.

The Court, however, has not addressed the situation in which a person comes into possession of material, nonpublic information in the context of a purely personal relationship, such as a family relationship or friendship. In such a situation, a person can receive information merely by sharing confidences incident to the personal relationship without the intent of offering a trading advantage. Because there are difficulties in finding a legally recognized relationship of trust and confidence between family members or friends, a violation of Rule 10b-5 may occur if an individual who receives information from a friend or family member uses that information in securities transactions.

This Article argues that the sharing of corporate information between family members and friends should be treated as if the information was acquired incident to a fiduciary relationship. Consequently, when the recipient of the information uses it to trade in securities, that person violates Rule 10b-5. Further, this Article presents a detailed discussion of the three U.S. Supreme Court decisions that define the connections between personal relationships and prohibited trading. Additionally, this Article presents the policy reasons for scrutinizing exchanges of information within personal relationships for evidence of 10b-5 violations. Finally, the Article discusses the SEC’s recent attempt to clarify this issue by rule.

*may prescribe* as necessary or appropriate in the public interest or for the protection of investors.


5. 521 U.S. at 650-53.


8. Id. at 652.
I. SUPREME COURT DOCTRINE ON INSIDER TRADING

The Supreme Court established the parameters of the prohibition against insider trading in three decisions:9 Chiarella v. United States,10 Dirks v. S.E.C.11 and United States v. O'Hagan.12 In Chiarella, the Court established that an individual trading in securities with material, nonpublic information must breach a fiduciary duty in order to violate Rule 10b-5.13 In this case, the defendant, an employee of a financial printing company, was accused of violating Rule 10b-5.14 During his employment, the defendant became aware of five corporate takeover bids.15 Prior to the announcement of the bids, the defendant purchased stock in the target companies; he sold the stock immediately after a public announcement of the bids and realized a profit of approximately $30 thousand.16

The Court characterized Chiarella as a case involving "the legal effect of [the defendant's] silence."17 Because neither the legislative history of section 10(b) nor the history of the SEC's Rule 10b-5 provided guidance with respect to silence, the Court reviewed SEC administrative precedent and federal court decisions to determine the scope of Rule 10b-5 as applied to the improper use of information.18

In Chiarella, the Court restricted the reach of In re Cady, Roberts & Co.19 In that case, the SEC determined that a corporate insider must abstain from trading in a corporation's shares until there was full disclosure of all material, nonpublic information.20 The SEC found that this obligation arose from two elements: (1) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose; and (2) the unfairness of allowing

---

9. See generally Carpenter v. United States, 484 U.S. 19 (1987) (illustrating a fourth decision where the Court was presented with criminal convictions for violations of Rule 10b-5 for trading on material, nonpublic information; however, the Court affirmed the mail and wire fraud convictions and rendered no opinion on the insider trading violations).
14. Id. at 224-25.
15. Id. at 224. The Court characterized four of the five takeover bids as tender offers. Id. at 224 n.1. The Court, however, characterized the fifth transaction as a merger. Id.
16. Id.
17. Id. at 226.
18. Id. at 226-30.
20. Id. at 912-15.
a corporate insider to take advantage of inside information without disclosure.\textsuperscript{21} The Court limited the reach of \textit{Cady, Roberts} by explicitly requiring a fiduciary duty between the parties to the transaction before a violation of Rule 10b-5 can occur.\textsuperscript{22} The Court determined that "the relationship between a corporate insider and the stockholders of his corporation [that] gives rise to a disclosure obligation is not a novel twist of the law."\textsuperscript{23} The Court also found that fraud at common law occurred only when the party failing to make a disclosure had a fiduciary obligation or other relationship of trust and confidence giving rise to a duty to disclose.\textsuperscript{24} The Court reviewed lower court decisions and its own previous decision in \textit{Affiliated Ute Citizens v. United States}\textsuperscript{25} and found

\textsuperscript{21.} \textit{Id.} at 912. \textit{Cady, Roberts} is not a case in which the corporate insider traded for his own account but rather is a tipping case. \textit{Id.} at 907. The director of the corporation conveyed information to the securities broker-dealer where he was employed and that firm traded for its own account. \textit{Id.} The Supreme Court has held that tipping violates Rule 10b-5. \textit{See infra} notes 87-88 and accompanying text.

\textsuperscript{22.} \textit{Chiarella}, 445 U.S. at 227-28.

\textsuperscript{23.} \textit{Id.} at 227.

\textsuperscript{24.} \textit{Id.} at 228. The Court also found that at common law "misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent." \textit{Id.} at 227-28. In addition, although the SEC can prohibit "any manipulative or deceptive device or contrivance," the SEC is not expressly given the power to define fraud. 15 U.S.C. § 78(j)(b). \textit{But see} United States v. O'Hagan, 521 U.S. 642, 653-58, 666-67, 670-73 (1997) (realizing the Supreme Court's effort to square the requirement of fraud with the different construction it gave section 14(e) because Congress, in that section, empowered the SEC to promulgate rules to prevent fraud).

\textsuperscript{25.} 406 U.S. 128 (1972). In \textit{Affiliated Ute}, the Court reviewed the special facts of the defendants' dealings with the plaintiffs. \textit{Id.} at 145-49. The Court concluded that the defendants were market-makers and thereby owed a duty of disclosure of material facts to the plaintiffs. \textit{Id.} at 153. The sole source of authority which the Court cited for this duty was \textit{Chasins v. Smith, Barney & Co.}, 438 F.2d 1167 (2d Cir. 1970), a federal case arising under Rule 10b-5. \textit{Id.} The Court did not rely on common law requirements, but concluded that there was a duty as a matter of federal law due to the special relationship between the plaintiffs and the defendants. \textit{Id.} at 152-53.

The lower court decisions on which the Court relied for the proposition that Rule 10b-5 cannot be violated in an omission of information case without a duty to disclose are inapposite. \textit{See, e.g., SEC v. Texas Gulf Sulphur Co.}, 401 F.2d 833 (2d Cir. 1968). The issue in \textit{Texas Gulf} was based on a premise that parties to a securities transaction are entitled to equal access to information, a policy expressly abandoned in \textit{Chiarella}. \textit{Chiarella}, 445 U.S. at 233. \textit{Frigitemp v. Financial Dynamics Fund, Inc.}, 524 F.2d 275 (2d Cir. 1975), involved plaintiffs who already possessed the material information in question, thus the Second Circuit did not decide the issue of duty to disclose. \textit{Id.} at 283. The Second Circuit's discussion on a duty to disclose merely pointed back to the Supreme Court's decision in \textit{Affiliated Ute}. \textit{Id.} at 282. Finally, \textit{General Time Corp. v. Talley Industries, Inc.}, 403 F.2d 159 (2d Cir. 1968), involved the issue of whether a corporation acquiring another corporation's stock in open market purchases had to disclose its plans before buying it. \textit{Id.} at 164. The Second Circuit found that an acquiring corporation ought to be able to use this information because the company should be rewarded for its
that these decisions were consistent with a requirement of a pre-existing relationship of trust and confidence, although they did not expressly nor exclusively rely on this element.\(^{26}\)

When the Supreme Court looked to common law fraud principles, it found that a duty to disclose was a necessary element to determine the limits of Rule 10b-5, and the Court established a precedent that led to the current state of insider trading law.\(^{27}\) Moreover, the Court never explained why it resorted to common law principles to determine disclosure and trading obligations under the federal securities laws.\(^{28}\)

Common law fraud doctrines exist in the context of commercial dealings.\(^{29}\) In public securities trading markets, buyers and sellers generally do not personally negotiate with each other and thus, a buyer or seller with material, nonpublic information can often conduct a transaction without disclosing his identity or the material information in his possession.\(^{30}\) Where there is a public trading market, questionable research and its willingness to assume substantial financial risks. Id. In any event, this case was decided before the effective date of sections 13(d), 14(d), and 14(e) of the 1934 Securities Exchange Act, which mandates this disclosure once more than five percent of the target’s stock is acquired or a tender offer for that stock is made. 15 U.S.C. §§ 78m(d), 78n(d), (e) (1997). The General Time court relied on the 1934 Act and its legislative history as support for concluding that the acquiring company had no obligation to disclose its plans under Rule 10b-5. General Time, 403 F. 2d at 164-65.

27. Id. at 227-28.
28. Id. at 227-29.

There has also been a growing recognition by common-law courts that the doctrines of fraud and deceit which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of such intangibles as advice and securities, and that, accordingly, the doctrines must be adapted to the merchandise in issue.

Id.; see also Harry Shulman, Civil Liability and the Securities Act, 43 Yale L.J. 227, 243-44 (1933-1934) (pointing out that defects in disclosure about stock need not harm the first purchaser). In a public trading market, securities can change hands multiple times before defects in disclosure are cured and the loss falls on the holder at the time disclosure is made. Id. at 230. Common law doctrines, such as breach of warranty claims, were not adapted to this particular feature of a public trading market. Id.

30. When there are negotiations, the case will not be purely disclosure issues, but may arguably involve misrepresentation or misleading statement issues. David S. Ruder, Texas Gulf Sulphur – The Second Round: Privity and State Mind in Rule 10b-5 Purchase and Sale Cases, 63 NW. U. L. Rev. 423, 437 n.77 (1968). Once discussions start between two parties interested in buying or selling securities, any discussions on the securities' value may be materially misleading, if not outright false. Id. No one wants to make a bad deal and most individuals will attempt to collect information to ascertain a security's value. See, e.g., Landreth Timber Co. v. Landreth, 471 U.S. 681 (1985) (finding that although corporate stock is invariably a security, the buyer of the stock, among other things, conducted an audit of the business). These cases are, therefore, different from transactions in public
insider trading generally involves nondisclosure. Since the federal securities laws were primarily aimed at regulating national trading markets in securities, where those laws were intended to fill shortcomings in state securities and common law, the Court should have considered the securities market context to determine which uses of material, nonpublic information would have been improper.

The Court did not provide any guidance with respect to the sources of law or custom that were relevant in determining whether there was a pre-existing relationship of trust and confidence. However, the Court's discussion of the duties of corporate insiders was instructive since the Supreme Court appeared to create a uniform duty for corporate insiders. The Court stated clearly that traditional corporate insiders owed a duty to disclose all material information to all buyers and sellers of a corporation's stock, or, in the alternative, to abstain from trading in their corporation's stock. State law precedent on corporate insiders' duties to shareholders, however, was not uniform and contained significant gaps.

Case law interpreting corporate officials' duties to stockholders when those officials bought stock gave rise to three approaches. The so-called majority view found that corporate insiders owed no fiduciary duty to stockholders when those insiders bought the company's stock. The markets where the buyer and seller do not need to know each other and any party having material, nonpublic information may be unable to cause public disclosure by the corporation whose securities' value are affected.

---

32. In Herman & MacLean v. Huddleston, 459 U.S. 375 (1983), the Court stated that: '[T]he anti fraud provisions of the securities laws are not coextensive with common-law doctrines of fraud. Indeed, an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct in the securities industry . . . . We therefore find reference to the common law in this instance unavailing.
459 U.S. at 388-89 (footnote and citations omitted).
34. Id. at 227-29.
35. Id. at 230.
36. This lack of uniformity in state law may, in part, result from the passage of the federal securities laws, since those laws have provided the primary basis for discussion of the misuse of material nonpublic corporate information for over sixty years. L. Loss, The Fiduciary Concept as Applied to Trading by Corporate "Insiders" in the United States, 33 MOD. L. REV. 34 (1970) (arguing that federal regulation "aborted" the development of the common law).
37. See 3A WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1168.10 (perm ed., rev. vol. 1994) (stating that the majority rule is that there is no fiduciary duty to stockholders); see also Bd. of Comm'ns v.
minority view found the exact opposite: corporate insiders always had a fiduciary duty to stockholders when buying corporate stock; there is a duty of full disclosure. At common law, there existed a third view. While, generally, corporate insiders owed no duty of disclosure to stockholders in buying corporate stock, “special circumstances” could arise from which courts could deem a duty to have been implied. Such circumstances could have included an insider’s knowledge of the impending sale of the company or the fact that an insider wished to buy company stock, facts a stockholder could not easily obtain upon inspection of corporate books and records.

While there were many state law cases where corporate insiders bought stock from existing shareholders, there was a dearth of state cases which held that a fiduciary duty exists when an insider sells stock to a non-stockholder. The only authority the Chiarella Court cites for this proposition is dicta in a federal case that does not decide a state law issue, but rather the scope and validity of section 16(b) of the Securities Act of 1934.

Reynolds, 44 Ind. 509, 513 (Ind. 1873) (finding no fiduciary duty to stockholders); Seitz v. Frey, 188 N.W. 266, 268 (Minn. 1922) (same); In re Clifton Trust, 93 A.2d 644, 647 (N.J. Super. Ct. Ch. Div. 1952) (same).


39. See, e.g., Strong v. Repide, 213 U.S. 419 (1909). In Strong, the Supreme Court, reviewed a decision of the Supreme Court of the Philippine Islands and found that, while there may be no general duty of a director to disclose to a shareholder his knowledge regarding a company, such a duty may arise if special facts exist. Id. at 431. The director of the company was negotiating the sale of the assets of the company and alone possessed knowledge on how those negotiations were progressing. Id. at 431-32. The director arranged to purchase shares while concealing that he was the buyer. Id. at 432. The negotiations for the sale of the company’s assets and the director’s identity were the special facts about which the Supreme Court found the failure to disclose constituted fraud. Id. at 432-33; see also Fox v. Cosgriff, 159 P.2d 224 (Idaho 1945) (finding a duty to disclose under special circumstances); Northern Trust Co. v. Essaness Theatres Corp., 108 N.E.2d 493 (Ill. App. Ct. 1952) (same).

40. See supra note 39.

41. There is no state case law where a shareholder who bought shares from a corporate insider was able to recover damages against the insider when it was later determined that the insider failed to disclose adverse information about the company. H. MANNE, INSIDER TRADING AND THE STOCK MARKET 23 (1966). An argument that liability should not rest with an insider for failure to disclose was made to the Securities and Exchange Commission in In re Cady, Roberts & Co., 40 S.E.C. 907, 913 (1961). The SEC rejected the argument saying: “This approach is too narrow. It ignores the plight of the buying public - wholly unprotected from the misuse of special information.” Id.

Diamond v. Oreamuno is a state law case which imposes liability on a corporate insider for selling his company’s shares when he had possession of material nonpublic adverse information. 248 N.E.2d 910 (N.Y. 1969). The court permitted the corporation to recover for the loss avoided by the insider. Id. at 913. The court found that the duty not to use the information was owed to the company, not to the stockholders. Id. at 913.
Exchange Act of 1934.\textsuperscript{42} Therefore, when the Supreme Court said that the "[a]pplication of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder’s welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information," the Court created a uniform fiduciary duty for corporate insiders under Rule 10b-5.\textsuperscript{43} The Court clearly indicated that traditional insider trading could violate Rule 10b-5 and proved willing to decide that, in the context of federal securities law, there exists a uniform relationship of trust and confidence for such insiders.\textsuperscript{44}

Although the Court strongly suggested that trading on material, nonpublic information by corporate insiders always violates Rule 10b-5,\textsuperscript{45} the Court’s formulation of corporate insider’s duties may only reach corporate insiders when they trade in their corporation’s stock. Hence, \textit{Chiarella} was not likely the last word on insider trading.

There are at least two instances where insiders may trade on material, nonpublic information about their own corporations if a duty is only owed to shareholders. The first is where the corporate insider trades in debt securities of the company.\textsuperscript{46} For example, an insider may become aware of developments that could favorably or unfavorably affect the

\textsuperscript{42} Chiarella v. United States, 445 U.S. 222, 227 n.8 (citing Gratz v. Claughton, 187 F.2d 46 (2d Cir. 1951)). As Judge Learned Hand stated in that case:

\begin{quote}
For many years a grave omission in our corporation law had been its indifference to dealings of directors or other corporate officers in the shares of their companies. When they bought shares, they came literally within the conventional prohibitions of the law of trusts; yet the decisions were strangely slack in so deciding. When they sold shares, it could indeed be argued that they were not dealing with a beneficiary, but with one whom his purchase made a beneficiary. That should not, however, have obscured the fact that the director or officer assumed a fiduciary relation to the buyer by the very sale; for it would be a sorry distinction to allow him to use the advantage of his position to induce the buyer into the position of a beneficiary, although he was forbidden to do so, once the buyer had become one.
\end{quote}

\textit{Gratz}, 187 F.2d at 49.

The case, however, actually involved issues in a shareholder’s derivative suit about the validity of and measurement of recovery under section 16(b) of the 1934 Securities Exchange Act, 15 U.S.C. § 78p(b) (1994), which permits the corporation to recover short-swing trading profits of a corporation’s director, officer, or ten percent stockholder. \textit{Id.} There is no holding in the case imposing any liability on insiders selling shares under state law in breach of a fiduciary duty owed to purchasers of the shares. \textit{See generally id.} Judge Learned Hand merely states in \textit{dicta} that such a result would be good policy. \textit{Id.} at 49.

\textsuperscript{44} \textit{Id.}
\textsuperscript{45} \textit{Id.}
\textsuperscript{46} \textit{Id.} at 232.
creditworthiness of the company. Instead of buying or selling corporate stock, the insider could trade in debt securities of the company. When the information regarding the company's creditworthiness becomes public, the price of the debt securities could be affected. Under state law, while insiders might owe duties to stockholders in trading stock, generally corporate insiders owe no duties to the corporation's creditors.47 There is no pre-existing relationship of trust and confidence between the insider and creditors.48 Consequently, trading in debt securities, even by a traditional corporate insider, may not violate Rule 10b-5 when such trading is viewed in light of the Chiarella rationale.49

Second, since there is no pre-existing relationship of trust and confidence between the insider and the other party to the transaction when the insider buys or sells options traded on a national securities exchange, an insider might use material, nonpublic information to trade in those securities.50 If the option being traded was a warrant issued by the corporation, a corporate insider might have a fiduciary duty to the warrant holder because a direct equity interest exists, but the issuer of exchange-traded options is the Options Clearing Corporation, not the corporation.51 These options can be created without the consent or participation of the corporation whose underlying stock the holder can

---

47. Eisenberg, Corporations and Other Business Organizations 932-33 (8th ed. 2000); see also Harff v. Kerkorian, 324 A.2d 215, 222 (Del. Ch. 1974), aff'd in pertinent part, 347 A.2d 133 (Del. 1975). If the corporation is insolvent, certain creditors will be the residual risk takers and the shareholders' claims will be worthless. In the case of insolvency, however, the directors may owe fiduciary duties to creditors. See, e.g., Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784 (Del. Ch. 1992).

48. Harff, 324 A.2d at 222.

49. However, the use of corporate information for trading in debt securities would be a "misappropriation" of information and would violate Rule 10b-5 under the reasoning of United States v. O'Hagan, 521 U.S. 642 (1997), discussed infra notes 109-16 and accompanying text.

50. An option is expressly included in the definition of "security" in both the 1933 Securities Act and the 1934 Securities Exchange Act. 15 U.S.C. § 77b(1)(1994); Id. § 78c(a)(10). A call option gives the holder the right to buy stock for a period of time at a set price. Blacks Law Dictionary 1121 (7th ed. 1999). A put option gives the holder the right to sell stock for a period of time at a set price. Id. Therefore, an insider may not owe a duty to the option holders. Laventhal v. Gen. Dynamics Corp., 704 F.2d 407 (8th Cir. 1983).

51. SEC, Special Study of the Options Markets 73-85 (1978) (providing a description of the special characteristics of exchange-traded options); see also 17 C.F.R. § 240.9b-1 (2000) (stating one of the special rules promulgated by the SEC to fit the exchange trading of options contracts within the federal securities laws disclosure system).
purchase or sell if the option is exercised. Consequently, the holders of the options have no existing relationship with the corporation. So long as a corporate insider only buys and sells exchange-traded options without buying or selling the corporation’s stock, the insider owes no duty to the other party to the transaction. To find a breach of Rule 10b-5 under these circumstances would require “recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information.” The Chiarella Court, however, would not find a breach of Rule 10b-5 without “some explicit evidence of congressional intent.”

The Chiarella Court suggested that Rule 10b-5 can prohibit traditional insiders from trading on material, nonpublic information, regardless of the security bought or sold. The Court’s requirement of a pre-existing relationship of trust and confidence, however, leaves doubt whether traditional insider trading on material, nonpublic information would always violate Rule 10b-5. Either the Court was broadly formulating duties for corporate insiders, regardless of the securities traded, or the Court was effectively setting forth the foundation for recognizing the misappropriation theory so that insiders could not evade the prohibition.

52. The holder of the option does not ever need to own the underlying stock. Although the holder can buy and then sell the option, he does not have to exercise the option provided the position is closed before expiration.

Similarly, an insider could negotiate a unique option contract with another party, usually a securities broker-dealer. Such privately negotiated option contracts, where the securities are purchased by corporate insiders, were the focal point in the seminal insider trading case SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 846-47 (2d Cir. 1968). The purchase of the call options in Texas Gulf predated commencement of exchange traded options in 1972. Id. at 843-47. While the Supreme Court in Chiarella cited Texas Gulf with apparent approval, no conclusion can necessarily be drawn regarding whether a fiduciary duty existed with respect to the call options. Chiarella v. United States, 445 U.S. 222, 229 (1980). The broker-dealer is the issuer of the option. Because this transaction is clearly at arm’s length, no duty to disclose information can be inferred. Any violation of Rule 10b-5 by an insider trading call options would have to be based on a different theory than the one accepted by the Court in Chiarella. See, e.g., Walton v. Morgan Stanley & Co., Inc., 623 F.2d 796, 798 (2d Cir. 1980). In addition, it is unlikely that the securities broker-dealer is harmed in any way. The securities broker-dealer should be knowledgeable about the securities markets when an insider wishes to negotiate an options contract. It is reasonable to conclude that the insider believes the broker-dealer has market moving information. In any event, it is only prudent for the broker-dealer to hedge the option since he has a built in profit and is hedged against any losses.

53. Laventhall, 704 F.2d at 414.
55. Id.
56. Id. at 226-29.
57. Id. at 230.
on the use of material, nonpublic information. The Court believed that trading by traditional insiders on material, nonpublic information violated Rule 10b-5 and, as such, the Court further concluded that insiders always owe a fiduciary duty to the corporation's stockholders. However, the Court was reluctant to venture into broad pronouncements on the use of information by outsiders to the corporation.

The Court's decision also raised questions about the scope of Rule 10b-5 with regard to trading in securities by outsiders to a corporation. Most outsiders to a publicly traded company owe no duty to the market in general. The Court stated that the mere possession of material, nonpublic information does not give rise to any duty to disclose the information before trading. What the Court left unresolved is whether the breach of duty to another party or misappropriation of another party's information, where the information obtained is used to trade on securities, can violate Rule 10b-5.

Of particular importance are situations where the party defrauded does not trade in securities and, therefore, no duty was owed to the other party in the securities transaction. In other words, while there may be fraud in connection with a securities transaction, if a securities trader cannot be defrauded, how can there be securities fraud?

This "misappropriation theory" raises several additional difficulties. Under this theory, an outsider, like the individual in Chiarella, would owe no general duty to the market. With no duty owed to a buyer or seller of securities, no one can privately enforce Rule 10b-5 even though acceptance of the "misappropriation theory" means the rule was violated. For example, where the party defrauded is an employer, but the employer is not the purchaser or seller, no duty is owed to the market or to the traders in securities. To find that a trader is able to sue

---

58. Id.
59. Id. at 234.
60. Id. at 232-33.
61. Id.
62. Id. at 235.
63. See generally id. In Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 749-55 (1975), the Court held that only purchasers or sellers of securities can enforce Rule 10b-5 in a private cause of action.
65. Id. See generally Chiarella, 445 U.S. at 224 (stating that the petitioner was not an outsider).
67. Id. at 14-15. In Moss, the Second Circuit ruled that even though there may be criminal violations of Rule 10b-5 on the same facts, persons who sold securities while the defendant traded securities have no cause of action against the defendant since there was
without a relationship of trust and confidence with the other party of the transaction is tantamount to finding that an action exists for mere possession of material, nonpublic information, a result clearly inconsistent with Chiarella.\(^6\)

Approximately three years after Chiarella the Supreme Court decided Dirks v. SEC.\(^6\) This case clarified when “tippees” of information would

---


69. 445 U.S. at 232. Congress added section 20A to the 1934 Securities Exchange Act which provides in relevant part:

Any person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.

15 U.S.C. § 78t-1(a) (1994). Congress acted out of fear that insiders might trade with parties who were not security holders of the corporation or that outsiders might be sued for violating Rule 10b-5. Congress provided contemporaneous traders with standing to sue persons misusing material, nonpublic information. \( id.\) While Congress permitted persons to whom no duty of disclosure was owed to enforce Rule 10b-5, it did not expressly recognize the “misappropriation theory.” Whether congressional action sanctioned the theory, however, was subject to argument. \(See, e.g., SEC v. Clark, 915 F.2d 439, 449-50 (9th Cir. 1990)\) (stating that the court used the legislative history, rather than the statutory language to support its conclusion that the “misappropriation theory” provided a basis for a Rule 10b-5 violation); \(see also\) Lawrence E. Mitchell, The Jurisprudence of the Misappropriation Theory and the New Insider Trading Legislation: From Fairness to Efficiency and Back, 52 ALB. L. REV. 775, 838 (1988) (discussing the duty requirement in Chiarella).
violate Rule 10b-5. The Court suggested that people could be “temporary insiders” bound by a duty to disclose or refrain from trading on material, nonpublic information. The Court suggested approval of the misappropriation theory. The Court left many of the questions that remained open after Chiarella unsettled.

Dirks, an insurance company securities analyst, received material, nonpublic information regarding fraudulent bookkeeping at Equity Funding of America from current and former employees of the company. As Dirks investigated, he shared the information he uncovered with clients and investors. Subsequently some of these investors sold their holdings of Equity Funding stock.

The SEC investigated Dirks' action and concluded: “Where ‘tippees’ – regardless of their motivation or occupation – come into possession of material ‘corporate information that they know is confidential and know or should know came from a corporate insider,’ they must either publicly disclose that information or refrain from trading.” The SEC, however, only censured Dirks and, by a divided panel, the Court of Appeals for the District of Columbia affirmed.

The Supreme Court reversed the court of appeals' decision. First, the Supreme Court reiterated what it said in Chiarella; specifically, a fiduciary relationship between the parties trading was a necessary prerequisite to establish a violation of Rule 10b-5 for insider trading. The Supreme Court stated that the “typical tippee has no such relationships [with shareholders].” Consequently, the SEC and the courts have had analytical difficulties in policing tippees.

70. Id. at 661-64.
71. Id. at 653.
72. See id. at 657-58.
73. Id. at 662-64.
74. Id. at 648-49. Ronald Secrist, a former officer of Equity Funding of America, told Dirks that the company's assets were “vastly overstated.” Id. at 649. While senior management of the company denied the fraud, other employees of Equity Funding confirmed Secrist's information. Id.
75. Id.
76. Id.
77. Id. at 651 (quoting 21 S.E.C. Docket 1401, 1407 (1981)).
78. Id. at 651-52.
79. Id. at 667.
80. Id. at 654-55.
81. Id. at 655.
82. Id.
According to the SEC, when Dirks received material, nonpublic information, he inherited the insiders’ duties to Equity Funding shareholders. The Supreme Court criticized this argument as being little different from the argument that the Court rejected in Chiarella. The Supreme Court made clear that the possession of material, nonpublic information does not, in and of itself, give rise to a duty to disclose or to refrain from trading. The Court went further and claimed that the SEC position “appears rooted in the idea that the antifraud provisions require equal information among all traders.” The Court likely overstated the SEC’s position on this point. While it may be inappropriate, in deciding the scope of insider trading, to distinguish between information sourced to the corporation and information arising outside the company, the SEC’s position, at most, advocates equal access to information sourced to the corporation because only insiders are likely to have duties of disclosure to shareholders.

While the Court rejected any automatically inherited derivative duty from insiders to tippees, the Court said that “[t]he need for a ban on some tippee trading is clear.” To hold otherwise would have allowed “devious dealings in the name of others that the trustee could not conduct [on] his own.” The Court reiterated what it said in Chiarella, that “[t]he tippee’s obligation has been viewed as arising from his role as a participant after the fact in the insider’s breach of a fiduciary duty.” Consequently, a breach of fiduciary duty occurs if the information is disclosed by an insider to a tippee for an improper purpose. The insider must personally benefit, directly or indirectly, from the disclosure. The breach of duty relates to the personal gain of the insider which may be pecuniary but can also be more intangible, such as a benefit to reputation.

83. Id. at 655-56.
84. Id. at 656.
85. Id. at 657.
86. Id.
87. See Chiarella v. United States, 445 U.S. 222, 240 n.1 (1980) (Burger, C.J., dissenting) (noting that “[a]cademic writing in recent years has distinguished between ‘corporate information’ — information which comes from within the corporation and reflects on expected earnings or assets — and ‘market information’ . . . . It is clear that § 10(b) and Rule 10b-5 by their terms and by their history make no such distinction”).
88. Dirks, 463 U.S. at 659.
89. Id. (quoting Mosser v. Darrow, 341 U.S. 267, 271 (1951)).
90. Id. (quoting Chiarella, 445 U.S. at 230 n.12).
91. Id. at 662 (stating that the insider releasing the information must benefit from the release for a breach of duty to occur).
92. Id. at 663.
that will translate into future earnings.\textsuperscript{93} Since Dirks was “a stranger to Equity Funding with no pre-existing fiduciary duty to its shareholders”\textsuperscript{94} and the insiders’ disclosure of information to Dirks was to expose fraud not for personal gain, the Supreme Court concluded that Dirks did not violate Rule 10b-5.\textsuperscript{95}

In \textit{Dirks}, the Court reiterated that possession of material, nonpublic information by itself was an insufficient basis to establish a Rule 10b-5 violation.\textsuperscript{96} However, the Court did clarify the law for temporary insiders, and suggested that the “misappropriation theory” could provide a basis for establishing a violation of Rule 10b-5.\textsuperscript{97} For tippee liability, the Court required the insider to disclose corporate information to the tippee with an improper purpose.\textsuperscript{98} Yet there are many circumstances where insiders may reveal corporate information legitimately to outsiders so they may perform services for the corporation’s benefit.\textsuperscript{99} The Court itself suggested that “an underwriter, accountant, lawyer, or consultant working for the corporation . . . may become fiduciaries of the shareholders.”\textsuperscript{100} These “temporary insiders” receive confidential information solely for corporate purposes.\textsuperscript{101} Their use of this information for trading in securities would make them primary violators of Rule 10b-5, not secondary violators like tippees.\textsuperscript{102}

The Court suggested in \textit{dicta} that misappropriation of information for trading in securities could violate Rule 10b-5.\textsuperscript{103} In discussing whether Dirks violated Rule 10b-5, the Court said that he did not “misappropriate or illegally obtain information about Equity Funding.”\textsuperscript{104}

\begin{thebibliography}{10}
\bibitem{93} \textit{Id.}
\bibitem{94} \textit{Id. at 665.}
\bibitem{95} \textit{Id. at 667.}
\bibitem{96} \textit{Id. at 654.}
\bibitem{97} \textit{Id. at 654-55, 659-60.}
\bibitem{98} \textit{Id. at 660.}
\bibitem{99} \textit{Id. at 655 n.1.}
\bibitem{100} \textit{Id. at 655 n.14.}
\bibitem{101} \textit{Id.}
\bibitem{102} \textit{Id. (citing Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974)).}
\bibitem{103} \textit{Id. at 660.}
\bibitem{104} \textit{Id. at 665.} \textit{SEC v. Lund} was the first case to apply this principle. 570 F. Supp. 1397, 1399-1403 (C.D. Cal. 1983). The defendant was not a corporate officer or employee of the company on whose information he traded. \textit{Id. at 1399.} He received his information from the company’s president when the president was seeking other participants in a nonpublic transaction. \textit{Id. at 1400.} The president was satisfying his duty to the corporation in communicating with the defendant so he could not be a tipper of the information. \textit{Id. at 1402.} But the court held the defendant as a temporary insider. \textit{Id. at}
The Court intimated that this factor could be considered to determine if Dirks violated Rule 10b-5.\(^{105}\)

Before the Supreme Court decided that the misappropriation of material, nonpublic information could provide a basis for a Rule 10b-5 violation, the Court considered the question of insider trading only once. In *Carpenter v. United States*,\(^{106}\) the Supreme Court did not decide whether the misappropriation theory was a valid basis because the Court was evenly divided on the issue.\(^{107}\) Instead, the eight justices decided that the misappropriation of the Wall Street Journal’s proprietary information to trade in securities for the personal profit of an employee and his tippees violated federal mail and wire fraud statutes.\(^{108}\) This holding had the paradoxical consequence of finding a criminal violation for a misuse of information for securities trading under a general federal antifraud statute, while failing to find a violation of the federal securities laws, which are more specifically directed to regulating trading in securities.\(^{109}\)

Finally, in 1997, the Supreme Court decided, in *United States v. O’Hagan*,\(^{110}\) that the misappropriation of information in breach of a fiduciary duty violated Rule 10b-5.\(^{111}\) O’Hagan worked as an attorney at the law firm of Dorsey & Whitney in Minneapolis, Minnesota.\(^{112}\) In July 1988, Grand Metropolitan PLC (Grand Met), a London based company, hired Dorsey & Whitney to represent it in connection with a potential tender offer for the stock of the Pillsbury Company.\(^{113}\) While Dorsey & Whitney was still representing Grand Met, O’Hagan bought Pillsbury call options with an expiration date in September 1988, and later purchased additional call options and five thousand shares of Pillsbury

---

1403. Since the defendant was dealing with the other corporation at arm’s length and not as a fiduciary, *id.* at 1400, this decision may be decided incorrectly.


107. *Id.* at 24.

108. *Id.* In that case, a writer for the Wall Street Journal leaked the contents of several “Heard on the Street” columns before publication. *Id.* at 22. Although the information in these columns was public and reliable, the packaging of the information about particular firms in a widely read column could move market prices of the subject company’s corporate stock prices. *Id.* Trading on this information yielded significant trading profits. *Id.* at 23.

109. *Id.* at 28.


111. *Id.* at 652.

112. *Id.* at 647.

113. *Id.*
common stock. After Grand Met's announcement of its tender offer for Pillsbury, O'Hagan sold his Pillsbury call options and stock for a profit of $4.3 million. The Eighth Circuit reversed O'Hagan's Rule 10b-5 convictions, finding that they could not be justified by using the "misappropriation theory." The Supreme Court disagreed, ruling that the misappropriation theory could provide a basis for a criminal conviction under Rule 10b-5.

The Supreme Court characterized the misappropriation theory as "hold[ing] that a person commits fraud 'in connection with' a securities transaction, and thereby violates [section] 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." The Court viewed this theory as a necessary complement to the classical theory espoused in Chiarella that corporate insiders could not trade on nonpublic information because they have a relationship of trust and confidence to stockholders. Although the classical theory only reaches insiders, the misappropriation theory reaches outsiders with no pre-existing duty to the security holders with whom they trade. The Court concluded that the section 10(b) requirement of deception is met under the misappropriation theory because there is non-disclosure of the scheme to trade securities to the source of the information. The fraud committed under the misappropriation theory is "in connection with the purchase or sale of [a] security" because the fraud is "consummated, not when the fiduciary gains the confidential information, but, when, without disclosure to his principal, he uses the information to purchase or sell...

114. Id. at 647-48. Because Grand Met's tender offer for Pillsbury was not announced until October 4, 1988, O'Hagan's profit on the purchase of these call options may not have come from the use of material, nonpublic information; the information on the takeover may already have been public. Id. at 647. O'Hagan pointed to news reports antedating his purchases that Grand Met was interested in acquiring Pillsbury. Id. at 648 n.1. O'Hagan's challenge remained open for consideration on remand. Id.

115. Id. at 648.

116. Id. at 649.

117. Id. at 666. The Eighth Circuit followed United States v. Bryan, which rejected the misappropriation theory. 58 F.3d 933, 944 (4th Cir. 1995). Three other courts of appeals had adopted the misappropriation theory. See United States v. Chestman, 947 F.2d 551, 566 (2d Cir. 1991); SEC v. Cherif, 933 F.2d 403, 410 (7th Cir. 1991); SEC v. Clark, 915 F.2d 439, 453 (9th Cir. 1990).


119. Id.

120. Id. at 652-53.

121. Id. at 653.
Additionally, and perhaps most importantly, the Court concluded that:

In sum, considering the inhibiting impact on market participation of trading on misappropriated information, and the Congressional purposes underlying § 10(b), it makes scant sense to hold a lawyer like O’Hagan as a § 10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works for a law firm representing the bidder. The Court struggled with precedent in reaching this decision. The Court’s willingness to find a violation of Rule 10b-5 when a duty is owed to someone other than a party to a securities transaction shows that the Court will recognize an insider trading violation when it believes that nonpublic material information is being abused. In Santa Fe Industries Inc. v. Green, the Court expressly held that a claim under Rule 10b-5 must be based on an element of deception. But under the misappropriation theory in O’Hagan, the party deceived is the party to whom a fiduciary duty is owed, not a buyer or seller of securities. The Supreme Court finds deception when:

Full disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no ‘deceptive device’ and thus no § 10(b) violation — although the fiduciary-turned-trader

122. Id. at 655-56.
123. Id. at 659.
124. See id. at 652.
126. Id. at 473-74. Santa Fe Industries owned ninety-five percent of the stock of Kirby Lumber Corporation. Id. at 462. Section 253 of the Delaware Corporation Law permits a parent corporation owning more than ninety percent of a subsidiary corporation’s stock to engage in a “short-form” merger. Id. The parent corporation’s board of directors can authorize the merger of its subsidiary into the parent without the subsidiary’s approval and can set the consideration to be given to the subsidiary’s minority stockholders. Id. Santa Fe’s board authorized such a merger with Kirby Lumber whereby the minority stockholders would receive cash. Id. at 466. The case came before the Court on the basis that “[t]he Complaint failed to allege a material misrepresentation or material failure to disclose.” Id. at 474. The minority shareholders’ complaint only raised questions of the fairness of the transaction. See id. at 462.
may remain liable under state law for breach of a duty of loyalty.

Under state law, however, breaches of the duty of loyalty usually involve both a breach of a duty of disclosure and an unfair transaction. These two elements are presumably present and tightly bound together because if there is disclosure of the questionable transaction, the party to whom the disclosure was made has the option to raise an objection to the transaction, commence litigation, or grant permission. In *Santa Fe Industries*, for example, the conceded full disclosure to minority stockholders served only to provide information to enforce state law claims, whether by seeking an appraisal of shares or a suit for breach of fiduciary duty. Otherwise, if permission is granted, there is no breach of the duty of loyalty or misappropriation of the information.

Yet the deception required to establish an action for federal securities fraud is the unfair use of information in a securities trading market and not the failure to tell an employer that information will be used to trade securities. The Court stated that a “fiduciary’s fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or

128. Id. at 655. Despite the fact that *Santa Fe Industries* was decided before *Chiarella v. United States*, in the latter case the Court spoke of Rule 10b-5 as prohibiting fraud, not manipulation or deception. *Chiarella v. United States*, 445 U.S. 222, 227-30 (1980).

129. *O'Hagen*, 521 U.S. at 655 (footnote omitted).

130. In *Globe Woolen*, Judge Cardozo found that a director of a corporation had breached his duty of loyalty and discussed this breach as one of the risks of the transaction and its unfairness. Id. at 379-81. Even in *Talbot v. James*, 190 S.E.2d 759 (S.C. 1972), where the court discussed the defendant’s breach in terms of failures of disclosure, the underlying transaction was unfair in that it was at variance with a previous agreement between the plaintiffs and the defendant. Id. at 764-65. The ALI divides the duty of loyalty into express obligations of disclosure and some inquiry into a transaction’s fairness. ALI, *PRINCIPLES OF CORPORATE GOVERNANCE ANALYSIS AND RECOMMENDATIONS* 199-207 (1994). The ALI tries to reward disclosure by lessening the judicial scrutiny into the transaction if the transaction was disclosed and approved by disinterested parties. Id. at 206.

131. *Santa Fe*, 430 U.S. at 466-68.

132. See, e.g., *Globe Woolen Co. v. Utica Gas & Electric Co.*, 121 N.E. 378 (N.Y. 1918). Permission granted after disclosure of conduct will be fully recognized only if the procedure for granting it is informed and fair. See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 856-57 (2d Cir. 1968) (discussing the obligations of persons with material, nonpublic information to whom the corporation granted stock options). The possibility existed that later ratification of the grant of these options by the corporation would at least cure any state law claim for breach of duty of loyalty. Id. Because the options in *Texas Gulf* were ratified without appreciation of the illegality of their grant, id., the ratification may have been flawed. However, disclosure with approval would negate any misappropriation of information.

sell securities.” The Court also stated that “[t]he securities transaction and the breach of duty thus coincide.” The Court conceded, however, that the consolidation of the transaction and the breach occurs “even though the person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information.”

This concession raises the question of how acceptance of the misappropriation theory squares with the Court’s previous reluctance to find violations of Rule 10b-5 when an individual breaches some state law duty. In Santa Fe Industries, the Court stated that:

To the extent that the Court of Appeals would rely on the use of the term “fraud” in Rule 10b-5 to bring within the ambit of the Rule all breaches of fiduciary duty in connection with a securities transaction, its interpretation would . . . “add a gloss to the operative language quite different from its commonly accepted meaning.”

Yet in O’Hagan, the Court did precisely the opposite.

In Santa Fe Industries, the Court rejected a claim that the payment of an unfair price by a controlling shareholder to a minority shareholder in a cash-out merger violated Rule 10b-5. Payment of an unfair price would breach the fiduciary duties the controlling stockholders owe the minority shareholders under state law. But without deception, misrepresentation or nondisclosure, directed toward the minority shareholders, the Court refused to find a violation of Rule 10b-5.

The Court has also refused to find a violation of the federal securities laws on the basis of breach of fiduciary duty covered by state corporate law. In Schreiber v. Burlington Northern, Inc., the Supreme Court again required misrepresentation or nondisclosure to establish a violation of the federal securities laws, specifically, under section 14(e) of the Securities Exchange Act of 1934. Faced with Burlington’s hostile bid for 25.1 million shares of El Paso Gas Company stock at $24 a share, El Paso’s management negotiated a friendly deal with Burlington.

134. Id. at 656.
135. Id.
137. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977) (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976)).
138. Id. at 474.
139. Id. at 478.
140. Id. at 480.
142. Id. at 8.
143. Id. at 2.
Burlington withdrew its original offer and made a second one, which consisted of $24 a share but for only twenty-one million shares and, in pertinent part, that Burlington would "recognize 'golden parachute' contracts between El Paso and four of its senior officers."

The plaintiff claimed that Burlington's withdrawal of the first offer and the substitution of the second "was a 'manipulative' distortion of the market for El Paso stock." The plaintiffs also argued that defendants violated section 14(e)'s prohibition by failing to disclose these "golden parachutes" to shareholders.

The Court found that violations of section 14(e) for manipulative acts required misrepresentation or nondisclosure and refused to find a violation on the basis of a breach of fiduciary duty covered by state corporate law.

One other Supreme Court decision strongly suggests that not every fraud, even those involving deception in securities transactions, will violate federal securities laws. In *Rubin v. United States*, a corporate vice president sought a secured loan from Bankers Trust to replace a temporary loan. Not only did the vice president misrepresent his corporation's financial position, but he also misrepresented the value and marketability of the stock his corporation would use as collateral.

In deciding that the pledge of securities to Bankers Trust constituted a sale and therefore federal securities laws applied, the Court cautioned that the misrepresentations related to the stock being pledged and therefore held that it did not have to decide whether the misstatements about the borrower's financial condition provided a basis for a violation of federal securities laws. Moreover, in *Marine Bank v. Weaver*, the Court noted

---

144. Id. at 3-4. The Court defined a golden parachute as "agreements between a corporation and its top officers which guarantee those officers continued employment, payment of a lump sum, or other benefits in the event of a change of corporate ownership." Id. at 3 n.2. One of the other terms of this offer was that Burlington would buy over four million shares at $24 a share directly from El Paso. Id. at 3. One consequence of this sale of stock to Burlington was to protect the friendly takeover. Id. Any bidder but Burlington would have to buy four million additional shares to take complete control of El Paso, at a cost to another bidder of as much as an additional $100 million. Id.

145. Id. at 4.

146. Id.

147. Id. at 12.


149. Id. at 425.

150. Id. at 426.

151. Id. at 429 n.6.
that "Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud."\textsuperscript{152}

When the Court decided \textit{O'Hagan}, it recognized that the misappropriation theory was a necessary adjunct to the classical theory of insider trading whereby insiders violate Rule 10b-5 when they trade their company's stock based on material, nonpublic information.\textsuperscript{153} Rule 10b-5 cannot be confined to finding liability where insiders trade and fully deal with information abuses in a trading market. In \textit{Chiarella}, the Court resorted to \textit{common law} to determine the scope of Rule 10b-5 and found that insider trading can only be based on a breach of a relationship of trust or confidence.\textsuperscript{154} This caused a convoluted development of the law. Additionally, the Court has created uniform federal fiduciary duties where there were none under state law,\textsuperscript{155} and found that fraud on a party not trading securities can give rise to a federal securities law violation, effectively enforcing state law obligations as a matter of federal securities law.\textsuperscript{156} Throughout, it is clear that the Court has found that trading on nonpublic information can violate Rule 10b-5 when the use of that information is unfair, regardless of the rhetoric in which the Court framed its decisions.

\section*{II. PERSONAL OR FAMILY RELATIONSHIP AS A BASIS FOR RULE 10B-5 VIOLATIONS}

The unsettled question is whether a personal or family relationship can provide a basis for Rule 10b-5 violations. To violate Rule 10b-5, there must be a misappropriation of information,\textsuperscript{157} and the friends or family members must have a fiduciary relationship between each other which is breached by trading in securities.\textsuperscript{158}

Determining whether a fiduciary relationship among family members or friends exists for purposes of Rule 10b-5 poses a dilemma. On one hand, the mere existence of a friendship or a family relationship does not

\footnotesize
\begin{itemize}
  \item \textsuperscript{152} 455 U.S. 551, 556 (1982) (citing \textit{Great Western Bank & Trust v. Kotz}, 532 F.2d 1252, 1253 (9th Cir. 1976); \textit{Bellah v. First Nat'l Bank}, 495 F.2d 1109, 1114 (5th Cir. 1974)).
  \item \textsuperscript{153} \textit{United States v. O'Hagan}, 521 U.S. 642, 651-52 (1997).
  \item \textsuperscript{154} \textit{Chiarella v. United States}, 445 U.S. 222, 227-29 (1980).
  \item \textsuperscript{155} \textit{Id.} at 230.
  \item \textsuperscript{156} \textit{Id.}
  \item \textsuperscript{157} \textit{O'Hagan}, 521 U.S. at 652.
  \item \textsuperscript{158} 17 C.F.R. § 240.10b5-2 (2000).
\end{itemize}
provide a basis under state law to find a confidential relationship.  

Something more is required; the quality of the relationship matters.

If state law controls for purposes of the federal securities laws, an inquiry would be made into the quality of private personal relations between individuals. However, an inquiry into the quality of personal relationships to determine if there is a fiduciary relationship is very different from merely concluding that a fiduciary relationship exists because there is a certain relationship between the parties. For example, a corporate employee owes fiduciary duties to the corporation regardless of the quality or nature of the employee’s work. Similarly, all partners owe a fiduciary duty to each other, without regard to how well the partners work together.

In addition, when state courts do not find a legally enforceable relationship of trust and confidence between all family members or friends, those courts are showing a reluctance to interfere with purely private concerns. Without a legally enforceable relationship, judicial relief would be unavailable. An inquiry into the quality of these relationships under Rule 10b-5 would breach this wall of privacy.

On the other hand, to find that certain family or personal relationships are always fiduciary in nature raises two separate issues. First, making this finding for the purpose of Rule 10b-5 would create a new legal relationship as a matter of federal law. Admittedly, the Court in Chiarella did not say what sources to look to in order to determine whether there is a relationship of trust and confidence, but rather created a uniform law for corporate insiders where there was no uniform state law. In the context of personal relationships, however, there is even less of a foundation under state law to legally conclude that a fiduciary relationship always exists among friends or family members.

For corporate insiders, some states have found that a fiduciary relationship

---


160. Id.

161. Id. at 705; see also United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991).


163. Id. at 652.


165. See supra notes 33-43 and accompanying text.

always exists with shareholders; however, state law generally does not find a confidential relationship on the basis of family ties alone.\textsuperscript{167} Concluding that certain personal and family relations are presumably fiduciary in nature conflicts with the Supreme Court's requirement that a pre-existing relationship of trust and confidence be expressly established.\textsuperscript{168}

This dilemma underscores the difficulties which arose as a result of the Supreme Court's insistence that a duty to disclose information only arises when there is a relationship of trust and confidence because, under the common law, such a duty was necessary in order to establish fraud.\textsuperscript{169} Instead, an inquiry should be made into whether, in the context of publicly traded securities, trading on nonpublic material information should be rewarded. There should be an incentive to find and analyze information so that securities can trade efficiently.\textsuperscript{170} Persons obtaining information, not by investigation or analysis but by virtue of position, however, should not be allowed to use that information for their own profit. This is particularly important where the use of the information prevents the owner of the information from fully exploiting it because of its premature disclosure.\textsuperscript{171} The status of parties such as corporate insiders, partners, or other trustees, can be used to capture traders whose use of information constitutes an unfair advantage. Consequently, information received by family members or personal friends should not be used for trading in securities.

The definition of family relationship or friendship does not need to be specific. In the case of family, the inquiry could be so basic as to establish that a relationship by blood or marriage exists. Similarly, for friends, the inquiry should only determine if the parties are strangers to each other. This broad formulation would not be over inclusive because the sharing of market moving information without improper tipping would be between parties who are closely related or are friends.

The fact that family relationships or friendships at common law do not invariably involve fiduciary duties should not matter. State courts are justifiably reluctant to adjudicate disputes between family members. Even if family members or friends are fiduciaries to each other under the

\textsuperscript{167} See supra notes 18-31 and accompanying text.
\textsuperscript{169} See supra text accompanying notes 21-27.
\textsuperscript{170} See supra notes 56-60 and accompanying text.
\textsuperscript{171} Dirks v. SEC, 463 U.S. 646, 658-59 (1983) (discussing why analysts should be encouraged to "ferret out and analyze information") (quoting 21 SEC Docket 1401, 1406 (1981)).
federal securities laws, the party to whom any duty is owed will not be a purchaser or seller of securities and, thus, he will be unable to sue under Rule 10b-5. Although a family member may be a defendant in a civil action, the plaintiff would likely be a stranger who contemporaneously traded with him.\(^{173}\)

III. SECURITIES AND EXCHANGE COMMISSION'S NEW RULE 10B5-2

In order to deal with the question of whether personal or family relationships can create liability under Rule 10b-5, the SEC adopted Rule 10b5-2, which provides:

_Preliminary Note to § 240.10b5-2:_ 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.

(a) _Scope of Rule._ This section shall apply to any violation of Section 10(b) of the Act (15 U.S.C. 78j(b)) and § 240.10b-5 thereunder that is based on the purchase or sale of securities on the basis of, or the communication of, material, nonpublic information misappropriated in breach of a duty of trust or confidence.

(b) _Enumerated “duties of trust or confidence.”_ For purposes of this section, a “duty of trust and 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 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. 174

The new rule is outside of the SEC's authority under Rule 10b-5 and is too narrow a view to address what may be possible. Rule 10b5-2(b)(1) directly contradicts the Supreme Court's rulings in Chiarella and Dirks that a relationship of trust and confidence must be breached to violate Rule 10b-5. 175 While the Rule's requirement of an agreement to keep information confidential is slightly different from saying possession of information, without more, can violate Rule 10b-5, a contractual agreement for confidentiality does not necessarily create a fiduciary duty. 176 Such information may be communicated in an arm's length transaction for proper purposes. An agreement to keep the information confidential does not create a fiduciary relationship. 177

The SEC claims that Rule 10b5-2 only embodies what case law has already acknowledged. 178 Yet any agreement on confidentiality must be linked with a pre-existing fiduciary relationship. 179 An agreement to keep information confidential in an arm's length negotiation establishes no fiduciary relationship or like relationship of trust and confidence. 180

175. See supra notes 15-31, 72 and accompanying text.
176. See, e.g., Walton v. Morgan Stanley & Co., 623 F. 2d 796, 799 (2d Cir. 1980) (holding that an agreement by an investment banker to hold a potential takeover target's financial information confidential created no fiduciary duty where the banker's client was dealing at arm's length with the target).
177. Id.
180. Walton, 623 F.2d at 799 (holding that a contract to keep certain information confidential did not create a fiduciary relationship where the recipient of the information was negotiating with the provider of the information on an arm's length basis).
Rule 10b5-2(b)(2) and (3) largely embody the test for a fiduciary relationship adopted by the Second Circuit, which in turn reflects common law standards. The SEC's new rule departs from the Second Circuit's test, however, in that a relationship with a spouse, parent, child, or sibling, is presumed to be a fiduciary relationship. Under the rule, any person charged with having a fiduciary relationship is given the chance to show that they had no history of sharing confidences or any expectation that the information would remain confidential.

The Supreme Court found that insiders owed a uniform fiduciary duty to shareholders even in the absence of a clear standard at state law. Fiduciary relationships previously recognized do not depend on the quality of any relationship. Two squabbling partners are just as much fiduciaries to each other as two cooperating partners. Thus, relationships with family members and friends should be conclusively presumed to be fiduciary in nature without inquiry into their quality.

IV. CONCLUSION

The unsettled question under Rule 10b-5 for abuse of material, nonpublic information in the context of personal dealings should be resolved so that family kinship or friendship provide a sufficient basis to find relationships of trust and confidence. When someone receives material, nonpublic information in the context of sharing personal confidence and uses that information to trade in securities, the person should be found in violation of Rule 10b-5 under the misappropriation theory.

Rule 10b5-2 has the advantage of being a non-inclusive rule. Nevertheless, Rule 10b-5 may be both overly broad and too narrow a view of what the SEC can do. The SEC should abandon any inquiry into the quality of relationships with family members and friends, and should simply conclude that they all involve relationships of trust and confidence.

---

was cited with approval by the Supreme Court in Dirks v. S.E.C., 463 U.S. 646, 662 n.22 (1983).

183. Id.
184. See supra notes 33-43 and accompanying text.