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Steven J. Cleveland

RESURRECTING DEFERENCE TO THE SECURITIES AND EXCHANGE COMMISSION: MARK CUBAN AND TRADING ON INSIDE INFORMATION

Steven J. Cleveland[*]

Abstract

By applying the Supreme Court's administrative law jurisprudence to the examination of the validity of Rule 10b5-2(b)(1)—a rule recently adopted by the Securities and Exchange Commission (Commission)—this Article fills a significant gap in the existing literature. To date, commentators have argued against the rule's validity by applying the Supreme Court's securities law jurisprudence without considering the role of administrative law—despite the Court's comments that the pertinent statute is ambiguous, despite express delegation of rulemaking authority by Congress to the Commission, and despite developments in administrative law subsequent to the Court's relevant securities law decisions. By not considering the role of administrative law, commentators have approached the rule with undue skepticism. Administrative law principles dictate judicial deference to the Commission's rule. The Commission once commanded deference from courts. The time has come to resurrect that deference.

* Professor of Law, University of Oklahoma College of Law; J.D., Georgetown University Law Center; B.A., UCLA.

INTRODUCTION

Mark Cuban earned billions during the Internet boom of the late 1990s; in the year 2000, he used some of those earnings to purchase a majority interest in the Dallas Mavericks, a member of the National Basketball Association (NBA).[1] Not content to watch his team from a luxury box high above the court, Cuban regularly sits courtside and, like other fans, enthusiastically comments on the action. Perhaps his enthusiasm has gotten the better of him; he has repeatedly and publicly criticized NBA referees and league officials. Perhaps not surprisingly, the NBA has fined Cuban multiple times for flouting its authority.[2] Cuban's run-ins with authority, however, have not been limited to the sporting realm.

In 2008, the Securities and Exchange Commission (Commission) accused Cuban of violating federal securities laws. According to the allegations of the Commission, the Chief Executive Officer of Mamma.com Inc. (MCI) contacted Cuban—who owned approximately 6% of the outstanding shares of MCI—and offered to share material, nonpublic information if Cuban agreed to maintain its confidentiality.[3] Cuban allegedly accepted those terms; after learning the information, however, he promptly sold his entire stake in the company.[4] Cuban sold his stock for approximately $13.30 per share on June 28 and 29, 2004—before the information became known publicly.[5] After the markets closed on June 29, 2004, MCI publicly disclosed the information; trading in the company's stock opened the following day at $11.89 per share, and ultimately closed that day at $11.99 per share.[6] By trading in advance of the disclosure of that material, nonpublic information, Cuban avoided the loss of more than $750,000.[7] The Commission

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1. *See* Mike Wise, *Despite Expectation, Magic Is Doing Well*, N.Y. TIMES, Jan. 9, 2000, at 85.

2. *See Timeline of Mark Cuban Fines*, ESPN (June 20, 2006), http://sports.espn.go.com/espn/wire?section=nba&id=2492950.

3. *See* Complaint at 3–5, SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009) (No. 08 Civ. 2050-D); *id.* at 5–6 (discussing the share price and amount of loss avoided). The information concerned a private investment in public equity (PIPE) offering. *See id.* at 3. Because a company is more likely to issue stock when its shares are overvalued, the market may respond negatively to news of an upcoming issuance. *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Hedge Fund Manager Hilary Shane with Insider Trading (May 18, 2005), *available at* http://www.sec.gov/news/press/2005-76.htm (alleging insider trading when insider shorted stock prior to public disclosure of PIPE offering); *see, e.g.*, JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 136 (6th ed. 2009) (noting the experience of Boston Chicken, Inc.).

4. Complaint, *supra* note 3, at 5.

5. *Id.*

6. *Id.* at 5–6.

7. *Id.* at 6.

accused Cuban of committing securities fraud by engaging in illegal insider trading.[8]

The district court dismissed the Commission's complaint, reasoning that even if Cuban agreed to maintain the company's confidences, he did not agree to forgo any securities trade based on the confidential information.[9] Trading, however, discloses information, even if it does so indirectly and imprecisely.[10] The Fifth Circuit determined that the allegations provided a plausible basis to conclude that Cuban understood that he was not to trade and that his agreement with the company was more than a simple confidentiality agreement.[11] Consequently, the Fifth Circuit found it unnecessary to identify the contours of a relationship of "trust and confidence," or to speak to the validity of Rule 10b5-2(b)(1), promulgated under § 10(b) of the Securities Exchange Act of 1934 (Exchange Act).[12]

Some of the leading business law scholars (BLS)—Professors Stephen Bainbridge, Alan Bromberg, Allen Ferrell, M. Todd Henderson, and Jonathan R. Macey—believe that, based upon Supreme Court precedent, illegal insider trading requires the breach of a fiduciary duty (or a similar duty of trust and confidence) when silence serves as the basis for the fraud.[13] Applying this rationale to the *Cuban* case, they conclude that Cuban could not have engaged in illegal insider trading, because a confidentiality agreement alone does not suffice to establish a fiduciary (or similar) relationship.[14] From their perspective, the Commission exceeded its authority by promulgating a rule imposing

8. *Id.* at 6–8.

9. *See* SEC v. Cuban, 634 F. Supp. 2d 713, 725–26, 731 (N.D. Tex. 2009).

10. *See* Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 336; Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 631 (1984) (noting that an insider's trade has communicative value, but is not an efficient means of communication); Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9, 56–57 (1984) ("[A duty may be] breached as much by wrongful disclosure as by wrongful trading."). In *Cuban*, the district court apparently failed to appreciate the communicative value of the defendant's trades. *See* 634 F. Supp. 2d at 725–26. Within a thirty-six-hour period, Cuban went from being the company's largest shareholder (with 6% of its shares) to owning zero shares of the company. *Id.* at 718. *But cf.* 15 U.S.C. § 78p(a) (2006) (requiring disclosure of trades by 10% owners of specified issuers' equity securities).

11. *See* SEC v. Cuban, 620 F.3d 551, 557–58 (5th Cir. 2010).

12. *Id*. at 558 & n.40.

13. *See* Brief of *Amici Curiae* Law Professors in Support of Defendant-Appellee at 10–16, SEC v. Cuban, 620 F.3d 551 (5th Cir. 2010) (No. 09-10996) [hereinafter BLS' Appellate Brief]; Amended Brief of *Amici Curiae* in Support of Defendant's Motion to Dismiss at 2–3, SEC v. Cuban, 634 F. Supp. 2d 713 (N.D. Tex. 2009) (No. 08 Civ. 2050-D) [hereinafter BLS' Trial Brief].

14. *See* BLS' Appellate Brief, *supra* note 13, at 21–22; BLS' Trial Brief, *supra* note 13, at 2–3.

insider-trading liability based upon the breach of a confidentiality agreement.[15]

This Article argues that the Commission did not exceed its authority.[16] Part I introduces background on the Commission's regulation of insider trading. Part II then challenges the underlying premise of the BLS that silence cannot be deceptive absent the breach of a fiduciary (or similar) duty. The BLS premise their argument on Supreme Court precedent interpreting the statute in cases involving insider trading, but they ignore the Court's precedent concerning administrative law. This Article fills a gap in the literature by considering the role of administrative law when addressing the validity of Rule 10b5-2(b)(1).

Contrary to the BLS' premise, the Supreme Court defines the scope of insider-trading liability only until the Commission offers an alternative, reasonable interpretation of statutory ambiguity.[17] In

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15. *See* BLS' Appellate Brief, *supra* note 13, at 21–27; BLS' Trial Brief, *supra* note 13, at 2–3. *See generally* Roberta S. Karmel, *Outsider Trading on Confidential Information—A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 95 (1998) ("There is little justification for making the breach of an agency or fiduciary duty to an employer, client, or similar beneficiary a federal, rather than a state law, claim unless a national economic interest is implicated.").

16. To be clear, this Article addresses whether the Commission possesses the power to promulgate Rule 10b5-2(b)(1), not whether the Commission should have promulgated the rule. Others have addressed whether the Commission should regulate insider trading. *See* HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 163–67 (1966) (opposing federal regulation); JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 282–89 (1982) (favoring federal regulation); Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881 (2010) (favoring federal regulation of outsider trading).

17. *See infra* Subsection II.B.1. This Article focuses on civil enforcement actions by the Commission, not private causes of actions implied by the courts. Private causes of action may subject defendants to abuse, *see* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995), and may be subject to limitations inapplicable to civil enforcement actions by the Commission. *See* United States v. Naftalin, 441 U.S. 768, 774 n.6 (1979) (distinguishing between governmental enforcement actions and potentially frivolous private litigation). Greater specificity might be required for purposes of criminal enforcement. *See* Crandon v. United States, 494 U.S. 152, 158 (1990) ("[I]t is appropriate to apply the rule of lenity in resolving any ambiguity in the ambit of the statute's coverage."); United States v. Chestman, 947 F.2d 551, 570 (2d Cir. 1991) (en banc) ("Useful as such an elastic and expedient definition of confidential relations, *i.e.*, relations of trust and confidence, may be in the civil context, it has no place in the criminal law."); United States v. Cassese, 273 F. Supp. 2d 481, 486 n.1, 488 (S.D.N.Y. 2003) (granting defendant's motion to dismiss criminal charges, noting that the Commission refused to bring civil enforcement action); Stephen Joyce, *Lawyers Say High Court Honest Services Case Will Hamper Prosecution of Corporate Fraud*, 42 Sec. Reg. & L. Rep. (BNA) 1824 (Sept. 27, 2010) (criticizing "controversial prosecutions in which the line between civil and criminal conduct was blurred" and in which "wrongdoing by breaching . . . fiduciary duties . . . might [be] . . . transformed into federal criminal fraud cases"); Yin Wilczek, *Judge, Attorneys Debate Vagueness of Standard for Securities Fraud Liability*, 42 Sec. Reg. & L. Rep. (BNA) 1541 (Aug 16, 2010) (discussing dismissal with

National Cable & Telecommunications Ass'n v. Brand X Internet Services, the Supreme Court held that a court's interpretation of an ambiguous statute does not prevent an administering agency from interpreting the statute differently, and the agency's interpretation, so long as it is reasonable, displaces that of the court.[18] So while the BLS may be correct that, when interpreting a statutory ambiguity, the Supreme Court has emphasized the violation of a fiduciary (or similar) duty before silence could constitute deception under § 10(b),[19] the Supreme Court's emphasis does not prohibit the Commission from interpreting that ambiguity differently. Moreover, in § 10(b), Congress expressly delegated rulemaking authority to the Commission. Consequently, courts should defer to the agency's reasonable interpretation regarding the party deceived, which interpretation the Commission forged in Rule 10b5-2(b)(1). In light of the text of § 10(b), its ambiguity regarding deception, and the Supreme Court's administrative law jurisprudence, courts should defer to the reasonable policy interpretations made by the Commission that result from notice-and-comment rulemaking. The Commission once commanded deference from the Court.[20] The time has come for resurrecting that deference.

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prejudice of criminal charges, but dismissal without prejudice of Commission's civil enforcement action).

18. *See* Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 983–84 (2005) ("Since *Chevron* teaches that a court's opinion as to the best reading of an ambiguous statute an agency is charged with administering is not authoritative, the agency's decision to construe that statute differently from a court does not say that the court's holding was legally wrong. Instead, the agency may, consistent with the court's holding, choose a different construction, since the agency remains the authoritative interpreter (within the limits of reason) of such statutes.").

19. *See infra* notes 37–40 and accompanying text.

20. *Compare* Int'l Bhd. of Teamsters v. Daniel, 439 U.S. 551, 566 n.20 (1979) ("It is a commonplace in our jurisprudence that an administrative agency's consistent, longstanding interpretation of the statute under which it operates is entitled to considerable weight."), United Hous. Found., Inc. v. Forman, 421 U.S. 837, 858 n.25 (1975) ("Traditionally the views of an agency charged with administering the governing statute would be entitled to considerable weight."), *and* SEC v. W.J. Howey Co., 328 U.S. 293, 299 n.5 (1946) ("The Commission has followed the same definition in its own administrative proceedings."), *with* Lampf v. Gilbertson, 501 U.S. 350, 354–55 (1991) (rejecting, without any reference to *Chevron*, the Commission's proposed limitations period for a private action under § 10(b)), Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197–99 (1976) (rejecting, without any reference to *Skidmore*, the Commission's interpretation regarding the defendant's mental state), *and* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 738–39, 746 n.10 (1975) (rejecting, without any reference to *Skidmore*, the Commission's interpretation regarding the plaintiff's standing). Though the Court largely accepted the Solicitor General's position in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008), the Commission articulated a contrary position in the lower courts; the Solicitor General prohibited the Commission from presenting that contrary position to the Court. *See* Linda Greenhouse, *Supreme Court Limits Lawsuits by Shareholders*, N.Y. TIMES, Jan. 16, 2008, at C1 ("The Securities and Exchange Commission supported the

I. THE REGULATION OF INSIDER TRADING GENERALLY

In 1934, Congress enacted the Securities Exchange Act, which created the Commission to administer the federal securities laws and included § 10(b).[21] Section 10(b) provides:

> It shall be unlawful for any person . . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[22]

Though it prohibited deceptive devices and contrivances,[23] Congress did not define any of those terms and it provided no specificity regarding the identification of the deceived party. By prohibiting deception "in connection with" the purchase or sale of a security, Congress intended to prohibit deception beyond that which occurs "in" or "during" a purchase or sale of securities.[24] That is, the statute prohibits more than a purchaser's deception of a seller and a seller's deception of a purchaser.[25] Consequently, the "in connection with" language certainly broadens the pool of persons who may have been deceived contrary to the statute, but Congress left ambiguous whose deception can constitute a violation.

In § 10(b), Congress prohibited nothing except that which contravenes rules that the Commission may promulgate. Thereby, Congress expressly delegated rulemaking authority to the Commission. Congress intentionally left a gap for the agency to fill.[26] Moreover, the

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plaintiffs . . . . [T]he S.E.C. was denied authority to file a brief. Justice Kennedy's opinion on Tuesday closely tracked the brief that Solicitor General Paul D. Clement eventually filed.").

21. 15 U.S.C. § 78d (2006).

22. *Id.* § 78j(b).

23. "Manipulative" is a term of art that has been defined narrowly. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476 (1977).

24. *See* United States v. O'Hagan, 521 U.S. 642, 652 (1997).

25. *See id.* at 658 ("The misappropriation theory comports with § 10(b)'s language, which requires deception 'in connection with the purchase or sale of any security,' not deception of an identifiable purchaser or seller."); United States v. Newman, 664 F.2d 12, 17 (2d Cir. 1981) ("[T]he language of Rule 10b-5 . . . contains no specific requirement that fraud be perpetrated upon the seller or buyer of securities.").

26. *See* Long Island Care at Home, Ltd. v. Coke, 551 U.S. 158 (2007).

> [T]he ultimate question is whether *Congress* would have intended, and expected, courts to treat an agency's rule, regulation, application of a statute, or other agency action as within, or outside, its delegation to the agency of 'gap-filling' authority. Where an agency rule sets forth important . . . duties, where the agency focuses fully and directly upon the issue, where the agency uses full

congressional language—"as necessary or appropriate in the public interest or for the protection of investors"—makes plain the general policy making authority that Congress delegated to the Commission.

An episode of insider trading reportedly prompted the Commission to exercise the authority granted by Congress under § 10(b) and to promulgate Rule 10b-5, which generally prohibits securities fraud. During the 1940s, a business executive falsely presented to his investors a bleak future for the company.[27] The false news prompted investors to sell their shares in the company, and the price of the company's securities consequently fell. Knowing that the company actually had a rosy future, the business executive then purchased shares of the company at a depressed price, which rebounded when the true state of affairs came to light. Because neither the federal statutes nor existing Commission rules clearly prohibited fraud in the purchase of shares (as opposed to fraud in the sale of shares), and because such behavior may be "contrary to the public interest" and may evidence a need for investor protection, the Commission promulgated Rule 10b-5.[28]

> notice-and-comment procedures to promulgate a rule, where the resulting rule falls within the statutory grant of authority, and where the rule itself is reasonable, then a court ordinarily assumes that Congress intended it to defer to the agency's determination.

Id. at 173–174.

27. For the factual background of this episode, see Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212 n.32 (1976).

28. As of this writing, 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 (2012). Though § 10(b) as originally enacted may not have been intended to prohibit insider trading generally, *see* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 429–30 (1990), subsequent congressional enactments support a view of § 10(b) that encompasses a prohibition of insider trading. *See generally* Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 2, 102 Stat. 4677 (1988); Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, §§ 1–2, 98 Stat. 1264 (1984).

Although each references "any person," neither § 10(b) nor Rule 10b-5 specifically references insiders or insider trading.[29] Section 10(b) speaks of "deceptive devices and contrivances." Rule 10b-5 speaks of "fraud, deceit, and materially misleading misstatements or omissions." Since enacting § 10(b), Congress has spoken of the evils of insider trading, but it has consciously avoided attempts to define insider trading.[30] Similarly, the Commission generally has eschewed defining insider trading for fear of providing a blueprint for mischief.[31] The Commission generally has utilized enforcement actions to establish the parameters of prohibited conduct on a case-by-case basis.[32] Consequently, the Commission, the courts, and the parties struggle to identify the parameters of legal conduct.[33]

Affirmative misrepresentations yield relatively straightforward analysis.[34] Misleading omissions that give rise to liability, however, have proved perplexing. If an outsider of the company works diligently

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29. *Cf.* 15 U.S.C. § 78p(b) (2006) (requiring disgorgement of short-swing trading profits by certain directors, officers, and large shareholders).

30. *See* H.R. REP. No. 100-910 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6048 ("While cognizant of the importance of providing clear guidelines for behavior [involving insider trading] which may be subject to stiff criminal and civil penalties, the Committee nevertheless declined to include a statutory definition in this bill . . . ."); H.R. REP. NO. 98-355 (1984), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2287 ("[E]vidence seems to show that any effort to define insider trading would result in, at best, a slightly less generalized rule than 10b-5 and, at worst, a rule that leaves gaping holes . . . .").

31. *See* Karmel, *supra* note 15, at 127 ("[T]he SEC is a prosecutorial agency that has long articulated the view that detailed regulations will be a blueprint for fraud and therefore it is better to rely upon general antifraud concepts to police the securities markets.").

32. *See* ROBERTA S. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VERSUS CORPORATE AMERICA 106 (1982) (suggesting that the SEC looks and thinks like a legal adversary of the securities industry); Karmel, *supra* note 15, at 126 ("[T]he SEC has developed its insider trading policies through ad hoc enforcement cases . . . .").

33. *See* Donald C. Langevoort, *The SEC as a Lawmaker: Choices about Investor Protection in the Face of Uncertainty*, 84 WASH. U. L. REV. 1591, 1622 (2006) ("While its motivations connect closely to historic values, insider trading doctrine itself is messy, incoherent, and result-oriented . . . ."). As is the case with other complicated areas of law, the analytical approach applicable to one area of regulated conduct may not apply with full force to a different area of that regulated conduct. *See generally* United States v. Stevens, 130 S. Ct. 1577, 1580 (2010) (rejecting the argument that courts should employ a balancing test to determine the applicability of First Amendment protection to animal cruelty videos, despite precedent calling for a balancing test to determine the applicability of First Amendment protection to other categories of speech).

34. For example, if Cuban intended to trade on the information at the time that he entered into the confidentiality agreement, then he would have affirmatively misrepresented his intent to maintain the information's confidentiality. *Cf.* SEC v. Dorozhko, 574 F.3d 42, 49–50 (2d Cir. 2009) (distinguishing between silence and affirmative misrepresentation to gain access to information); SEC v. Cherif, 933 F.2d 403, 406 (7th Cir. 1991) (describing a former employee who, despite his termination, misrepresented his ongoing employment with the source to continue access to material, nonpublic information).

and (legally) unearths information that enables her to trade profitably in the company's securities, then she should retain the profits from the trade as the fruits of her labor. Requiring her to disclose the information to others before allowing her to trade would decrease or eliminate her profit and discourage her diligent quest for valuable information. Such diligence, however, should be encouraged, not discouraged.[35] Though it may have been advocated in individual cases, neither the Commission nor the Supreme Court has supported the parity of information rationale, which would require one who discovers information either to abstain from trading or disclose the information to others before trading.[36]

Rejecting the parity of information rationale, however, does nothing to provide a coherent rationale for imposing liability stemming from one's silence. Typically, silence is not troubling in a transaction. *Caveat emptor* frequently provides the rule of thumb. *Caveat emptor* applies more easily when tangible property, as opposed to stock, changes hands. Further complicating the analysis, stock is routinely traded impersonally. Without personal interaction, silence is what one expects to hear from the counterparty, so silence generally does not mislead.

Given Congress's and the Commission's prior unwillingness to provide the requisite guidance, courts have filled the void. As to whether silence may constitute the deception required by § 10(b) and Rule 10b-5, the judiciary has premised insider-trading liability on a breach of fiduciary duty.[37] The Supreme Court described the principal theories of liability for such insider trading to include the following: (1) when an insider breaches a fiduciary duty by trading on the basis of material, nonpublic information;[38] (2) when an insider, in breach of a fiduciary duty, tips a third party who knows or should know of the breach and who trades on the basis of material, nonpublic information;[39]

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35. *See* HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET 131–45 (1966) (discussing the entrepreneur's compensation).

36. *See* Karmel, *supra* note 15, at 89 ("[T]he parity of information theory has not been accepted by the Supreme Court or the SEC itself.").

37. *See* Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1590 (1999). Aside from Section 10(b) and Rule 10b-5, the federal government otherwise relegates insider trading. *See, e.g.*, 15 U.S.C. § 78p(b) (2006) (requiring disgorgement of short-swing profits obtained by certain directors and officers).

38. *See* Chiarella v. United States, 445 U.S. 222, 227–29 (1980); *id*. at 230 ("Application 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 prohibition extends to temporary insiders. *See* Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983) ("Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders.").

39. *See Dirks*, 463 U.S. at 660 ("[A] tippee assumes a fiduciary duty to the shareholders

and (3) when an outsider trades on the basis of material, nonpublic information misappropriated in breach of a fiduciary duty to the source of that information.[40]

Long advocated by the Commission, the third theory—the misappropriation theory—was most recently accepted by the Supreme Court, and it is the misappropriation theory that gave rise to Rule 10b5-2(b)(1), the rule at issue in the case against Mark Cuban. But first, a few words on the Supreme Court's decision to embrace the misappropriation theory, according to which the deceived party is *not* the counterparty to the trade.

In *United States v. O'Hagan*, Grand Metropolitan PLC (Grand Met) formed a secret plan to acquire the Pillsbury Company.[41] Such an acquisition, on a per-share basis, would *not* occur at the price listed on a stock exchange. An exchange lists the price for one share, a relatively inconsequential amount. Grant Met did not want to purchase a relatively inconsequential amount; it wanted to buy control of Pillsbury. To acquire control, one must pay a premium above the price listed on an exchange.[42] Grand Met maintained the secrecy of its plan, because if news of its plan leaked to the public, then the price for Pillsbury would have risen and jeopardized the success of the planned acquisition.[43]

To facilitate its plan, Grand Met retained counsel in Minnesota, where Pillsbury was headquartered.[44] James Herman O'Hagan—who was an attorney at the Minnesota law firm, but was not personally representing Grand Met—learned of the planned acquisition from an attorney at his law firm who was representing Grand Met.[45] O'Hagan then acquired securities issued by Pillsbury, knowing that their value would increase when Grand Met eventually announced its plan to the

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of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.").

40. United States v. O'Hagan, 521 U.S. 642, 647 (1997) ("Is a person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, guilty of violating § 10(b) and Rule 10b-5? . . . [Y]es . . . .").

41. For the factual background of the case, see *O'Hagan*, 521 U.S. at 647–48.

42. *See* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 43 (Del. 1994) ("The acquisition of majority status and the consequent privilege of exerting the powers of majority ownership come at a price. That price is usually a control premium which recognizes not only the value of a control block of shares, but also compensates the minority stockholders for their resulting loss of voting power."); JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATIONS 1137 (6th ed. 2004) ("Of course, stock market value represented the value of minority shares because controlling shares do not trade.").

43. *See* Macey, *supra* note 10, at 25.

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

45. *Id.* at 647, 649 n.1.

public.[46] Following Grand Met's public announcement, O'Hagan profited on the sales of his Pillsbury securities.[47] O'Hagan appealed criminal convictions on numerous counts of violating, among other federal securities laws and regulations, § 10(b) and Rule 10b-5.[48]

Then-existing Supreme Court precedent interpreting § 10(b) and Rule 10b-5 may not have sufficed to discipline O'Hagan.[49] O'Hagan was not a fiduciary or insider of Pillsbury, in whose securities he traded.[50] Shareholders of Pillsbury had not placed their trust in him. No one at Pillsbury, in whose securities O'Hagan traded, had tipped him about the acquisition. Pillsbury—like the market at large—was ignorant of Grand Met's secret plan at the time of O'Hagan's trades.

The Commission had long pursued defendants under a theory of misappropriation, which had divided the circuit courts of appeals.[51] Twice before, the Supreme Court had been presented with the question whether liability under § 10(b) could be based upon the misappropriation theory, but in one case, the theory had not been presented to the jury, and in the other case, the Court divided evenly on the issue.[52] Given a third opportunity, the Court upheld the validity of the misappropriation theory. "[T]he 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."[53] The statutorily required deception is perpetrated on the source of the confidential information to whom the fiduciary "feign[ed] fidelity."[54]

"Although the Court . . . approved the misappropriation theory in . . . *O'Hagan*, it did not develop a broad doctrine or policy rationale [to] . . . assist the lower courts in distinguishing between lawful and unlawful outsider trading."[55] Though it may be advisable for the Court

46. *Id.* at 647.

47. *Id.* at 648.

48. *Id.* at 648–49.

49. *See id.* at 653 n.5.

50. *Id.*

51. *Compare* United States v. Chestman, 947 F.2d 551, 566 (2d Cir. 1991) (en banc) (upholding the validity of the misappropriation theory), SEC v. Cherif, 933 F.2d 403, 410 (7th Cir. 1991) (same), *and* SEC v. Clark, 915 F.2d 439, 453 (9th Cir. 1990) (same), *with* United States v. O'Hagan, 92 F.3d 612, 613–14 (8th Cir. 1996) (rejecting the validity of the misappropriation theory), *and* United States v. Bryan, 58 F.3d 933, 943-59 (4th Cir. 1995) (same).

52. *See* Chiarella v. United States, 445 U.S. 222, 235–36 (1980); Carpenter v. United States, 484 U.S. 19, 24 (1987); *see also* Dirks v. SEC, 463 U.S. 646, 665 (1983) (noting that the defendant did not misappropriate the information used by others to trade profitably).

53. *O'Hagan*, 521 U.S. at 652–53.

54. *Id.* at 655; *see id.* at 652 ("[A] fiduciary's undisclosed, self-serving use of a principal's information . . . defrauds the principal of the exclusive use of that information.").

55. Karmel, *supra* note 15, at 84.

to issue narrow rulings,[56] the Commission has been criticized for regulating on a case-by-case basis, instead of promulgating broad rules that facilitate transaction planning and dispute resolution. Following the Court's decision in *United States v. O'Hagan*, the Commission promulgated a new rule.[57] Rule 10b5-2(b)(1) provides a nonexclusive basis for liability under the misappropriation theory; the requisite duty exists "[w]henever a person agrees to maintain information in confidence."[58]

II. THE COMMISSION'S REGULATION OF SILENCE AS DECEPTION

According to the BLS, Supreme Court precedent requires the breach of a fiduciary (or similar) duty before silence can be deceptive in a securities trade. And, the argument continues, because a simple confidentiality agreement alone does not give rise to a fiduciary (or similar) relationship, the Commission exceeded its authority in

56. *See* Cass R. Sunstein, *The Supreme Court 1995 Term: Foreword: Leaving Things Undecided*, 110 HARV. L. REV. 4, 7 (1996).

57. *See* Selective Disclosure and Insider Trading, 65 Fed. Reg. 51716, 51734 (Aug. 24, 2000) (codified at 17 C.F.R. pt. 240 (2012)) ("[T]he rule will provide greater clarity and certainty to the law . . . .").

58. 17 C.F.R. § 240.10b5-2(b)(1) (2012). Rule 10b5-2(a) provides that "[t]his section shall apply to any violation of Section 10(b) of the Act . . . and [Rule 10b-5] thereunder that is based on the purchase or sale of securities on the basis of, or the communication of, material nonpublic information misappropriated in breach of a duty of trust or confidence." *Id.* § 240.10b5-2(a).

Some scholars note the distinction between the Supreme Court's language (duty of trust *and* confidence) and the language of the Commission's rule (duty of trust *or* confidence). *See* Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1360 (2009). In this instance, emphasis on the *and*/*or* distinction may be misplaced. First, Congress, not the Supreme Court, delineates the reach of § 10(b), *see* U.S. CONST. art. I, §§ 7, 8, and the statute speaks of deception. The Supreme Court's "and" (rather than the Commission's "or") is not critical to deception. *See* W. Page Keeton, *Fraud—Concealment and Non-Disclosure*, 15 TEX. L. REV. 1, 12 (1936) (noting that silence can be deceptive where "one . . . of the parties expressly reposes a trust *or* confidence in the other") (emphasis added). Second, "confidence" and "trust" overlap. Webster's Dictionary defines "confidence" as "a relation of trust." WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 275 (1983) (definition 3a). "Trust" is defined as "one in which confidence is placed." *Id*. at 1268 (definition 1b). Despite the overlap of their meaning, one might be inclined to interpret the words "trust" and "confidence" to mean different things; otherwise, there is no reason to use two words when one would do. The Supreme Court, however, used the singular—*duty* of trust and confidence—as opposed to the plural—*duties* of trust and confidence, suggesting that the Court employed overlapping rhetoric, never intending emphasis on any possible distinction between "trust" and "confidence." *But see* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (referencing the "duties of care and loyalty" to indicate separate and distinct concepts). Finally, the Supreme Court has criticized hypertechnical interpretations of the Exchange Act, *see* SEC v. Zandford, 535 U.S. 813, 819 (2002) ("construed, not technically and restrictively, but flexibly . . . .") (internal quotation marks omitted), so one need not hypertechnically construe rhetorical dicta included in its opinions interpreting the Exchange Act.

promulgating Rule 10b5-2(b)(1). The BLS, however, misperceive congressional allocation of interpretive authority between the courts and the Commission. Contrary to the position espoused in the writings of the BLS, the Commission, in promulgating Rule 10b5-2(b)(1), acted consistent with § 10(b) and with the Supreme Court's administrative law and securities law precedent.

Congress unquestionably wields the power to legislate,[59] but it inevitably enacts ambiguous statutes.[60] Consequently, the resolution of statutory ambiguity is a pervasive problem. In the absence of congressional clarification, who should resolve the ambiguity—a court, or the agency charged by Congress to administer the ambiguous statute? In *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*,[61] the Supreme Court formalized its practice of according weight to the position articulated by an administering agency: If Congress did not squarely address the issue and if the administering agency's interpretation of the statutory ambiguity is reasonable, then a court should defer to the agency's interpretation, even if the court might have interpreted the ambiguity differently.[62]

Consequently, analysis under *Chevron* generally involves a two-step inquiry. Step One involves the determination of whether the statute is ambiguous. Step Two involves the determination of whether the agency's interpretation is reasonable. Because the Court has not always applied *Chevron* analysis, despite its apparent applicability, some conclude that the Court undertakes a preliminary determination before applying *Chevron*'s two steps, with the preliminary determination termed "Step Zero."[63] So, for example, some matters might be deemed too significant for Congress to have delegated their resolution to an agency, such as the regulation of physician-assisted suicide.[64] Congress,

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59. *See* U.S. CONST. art. I, §§ 7, 8.

60. *See generally* Muscarello v. United States, 524 U.S. 125 (1998) (interpreting the phrase "carries a firearm"); *id.* at 144 n.6 (Ginsburg, J., dissenting) ("And in the television series 'M*A*S*H,' Hawkeye Pierce (played by Alan Alda) presciently proclaims: 'I will not carry a gun. . . . I'll carry your books, I'll carry a torch, I'll carry a tune, I'll carry on, carry over, carry forward, Cary Grant, cash and carry, carry me back to Old Virginia, I'll even hari-kari if you show me how, but I will not carry a gun!'") (citation omitted).

61. Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837 (1984).

62. *See id.* at 842–44; Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2887 (2010) ("[The Court must] accept . . . those agency interpretations that are reasonable in light of the principles of construction courts normally employ.") (citation omitted) (internal quotation marks omitted).

63. Thomas W. Merrill & Kristin E. Hickman, Chevron*'s Domain*, 89 GEO. L.J. 833, 873 (2001); Cass R. Sunstein, Chevron *Step Zero*, 92 VA. L. REV. 187 (2006) (discussing considerations that might arise prior to *Chevron* Step One). Congress, however, delegated to the Commission rulemaking authority in § 10(b), empowering the Commission to identify those deceptive practices that will be prohibited.

64. *See* Gonzales v. Oregon, 546 U.S. 243, 267–68 (2006) ("The importance of the issue

however, delegated significant authority to the Commission, including interpretative authority regarding § 10(b).

A. *Congressional Delegation to the Commission*

A statutory ambiguity leaves room for an agency to fill the gap, but Congress must have charged the agency with administering the ambiguous statute.[65] Congress created the Commission to administer the Exchange Act.[66] Congress granted the Commission rulemaking authority generally and, in particular, with respect to § 10(b).[67] Congress empowered the Commission to investigate statutory and rules violations.[68] Congress empowered the Commission to conduct administrative cease-and-desist proceedings for present, past, or future statutory and rules violations,[69] as well as general administrative proceedings.[70] In addition to administrative proceedings, the Commission may pursue injunctions, fines, and penalties in federal court.[71] In light of these far-ranging delegated powers, and in particular

of physician-assisted suicide, which has been the subject of an earnest and profound debate across the country, makes the oblique form of the claimed delegation all the more suspect.") (citation omitted) (internal quotation marks omitted); Whitman v. Am. Trucking Ass'ns, 531 U.S. 457, 468 (2001) ("Congress, we have held, does not alter the fundamental details of a regulatory scheme in vague terms or ancillary provisions—it does not, one might say, hide elephants in mouseholes."); FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 160 (2000) ("[W]e are confident that Congress could not have intended to delegate a decision of such economic and political significance to an agency in so cryptic a fashion.").

65. *Compare* SEC v. Zandford, 535 U.S. 813, 819–20 (2002) ("[The SEC's] interpretation of the ambiguous text of § 10(b), in the context of formal adjudication, is entitled to deference if it is reasonable, see *United States* v. *Mead Corp.*, 533 U.S. 218, 229–30, and n. 12 (2001)."), *with* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 152–53 (2008) (refusing to defer to the Commission's position presented in a private cause of action where the Commission was not administering the statute).

66. *See* 15 U.S.C. § 78d(a) (2006); Central Bank of Denver v. First Interstate Bank, 511 U.S. 164, 173 (1994) ("[Congress] envisioned that the SEC would enforce the statutory prohibition [of Section 10(b)] through administrative and injunctive actions.").

67. *See* 15 U.S.C. § 78j(b) (2006) ("It shall be unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."); *id.* § 78w(a)(1) ("The Commission . . . shall . . . have power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this chapter for which [it is] responsible or for the execution of the functions vested in [it] by this chapter . . . .").

68. *See id.* §§ 78u(a), (c).

69. *See id.* § 78u-3.

70. *See id.* §§ 78o(c)(4), 78u-2; Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 929P, 124 Stat. 1376, 1862 (2010) (expanding coverage to all persons, not just those associated with registered entities).

71. *See* 15 U.S.C. §§ 78u(d), 78u-1, 78aa (2006).

the rulemaking authority granted under § 10(b), Congress intended the Commission to fill statutory gaps and, in particular, gaps in § 10(b).[72]

Concluding that the Commission has the authority to fill a statutory gap does not end the inquiry. Deference follows agency positions that have the force of law. A position has the force of law if it results from formal adjudication or notice-and-comment rulemaking.[73] The Court previously has deferred to the Commission's interpretation of an ambiguity of § 10(b) in the context of a formal adjudication.[74] Rule

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72. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202–03 (1975) (stating that § 10(b) was intended as a "catch-all" and that the "Commission should have the authority to deal with new manipulative devices") (quoting Thomas G. Corcoran, who is credited as a coauthor of federal securities regulation of the 1930s, *see* ROBERT A. CARO, THE YEARS OF LYNDON JOHNSON: THE PATH TO POWER 322, 326 (1982)); *see also* COX, *supra* note 3 ("[T]he Exchange Act is in large part a laundry list of problems for which Congress articulated neither the means nor the end objective. Instead, Congress . . . created the Securities and Exchange Commission and delegated to it the task of grappling with the problem areas."); *cf.* Gonzales v. Oregon, 546 U.S. 243, 259–60 (2006) (according less deference to an agency position when Congress delegated only limited powers to be exercised in limited ways). The statutory ambiguities that gave rise to Rule 10b5-2(b)(1) fall within the Commission's domain, but there may be certain ambiguities regarding § 10(b) that Congress intended the courts—not the Commission—to resolve. For example, Congress may have intended the courts—not the Commission—to determine the scope of *private* causes of action. *See* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 152–53 (2008); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 746 n.10 (1975); Lisa Schultz Bressman, *Chevron's Mistake*, 58 DUKE L.J. 549, 579 (2009) ("Congress likely intended courts to interpret the PSLRA or at least knew that they would. The explanation is straightforward: courts have been the primary interpreters of securities law in the context of private class actions."). When private parties litigate, the Commission may play a diminished role. Given the potential abuse posed by private plaintiffs, the scope of private causes of action might be a matter deemed too significant for Congress to have delegated its resolution to an agency, such that *Chevron* deference may not be appropriate. *See Gonzales*, 546 U.S. at 267 ("The importance of the issue . . . , which has been the subject of an earnest and profound debate across the country, makes the oblique form of the claimed delegation all the more suspect.") (citation omitted) (internal quotation marks omitted); FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 160 (2000) ("[W]e are confident that Congress could not have intended to delegate a decision of such economic and political significance to an agency in so cryptic a fashion."). However, misappropriation principally arises in public enforcement actions, rather than private lawsuits, *see* Matthew A. Aufman, Note, *Civil Liability under Exchange Act Rule 10b-5 for Misappropriators of Nonpublic Information: An Argument for Consistency*, 40 B.C. L. REV. 829, 849 (1999) ("Few lawsuits have been brought to date under the misappropriation theory of Rule 10b-5 . . . ."), because the deceived source may have neither purchased nor sold securities, *see Blue Chip Stamps*, 421 U.S. at 738–39, and because of the difficulty faced by third-party traders in establishing causation and reliance. *See Stoneridge*, 552 U.S. at 152–53.

73. *Compare* United States v. Mead Corp., 533 U.S. 218, 226–27 (2001) ("[Congressionally] delegated authority . . . carrying the force of law . . . may be shown . . . by an agency's power to engage in adjudication or notice-and-comment rulemaking . . . ."), *with* Christensen v. Harris Cnty., 529 U.S. 576, 587 (2000) ("Interpretations such as those in . . . policy statements, agency manuals, and enforcement guidelines, all of which lack the force of law—do not warrant *Chevron*-style deference.").

74. *See* SEC v. Zandford, 535 U.S. 813, 819–20 (2002) ("[The SEC's] interpretation of

10b5-2(b)(1) resulted from formal notice-and-comment rulemaking,[75] and should command judicial deference so long as the statute is ambiguous and the Commission's rule reasonably resolves the ambiguity.

B. *Statutory Ambiguity*

A court owes no deference to an administrative agency regarding an issue on which the statute is unambiguous.[76] The Exchange Act, however, is ambiguous regarding the points for which the Commission promulgated Rule 10b5-2(b)(1). In § 10(b) of the Exchange Act, Congress prohibited deception in connection with the purchase or sale of a security. Congress provided no guidance regarding what parties might be deceived.[77] Moreover, Congress did not prohibit deception "in" or "during" the purchase or sale of a security; it prohibited deception "in connection with" the purchase or sale of a security. The language "in connection with" makes it plain that Congress intended to protect parties beyond a deceived seller or a deceived purchaser. Congress, however, gave no additional guidance. Consequently, the Commission could promulgate a rule regarding the deception of a source of confidential nonpublic information.[78]

To the extent that one finds legislative history persuasive,[79] Congress has contemplated imposing liability under the securities laws for misappropriating information in violation of contractual

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the ambiguous text of § 10(b), in the context of formal adjudication, is entitled to deference if it is reasonable, see *United States v. Mead Corp*., 533 U.S. 218, 229–30, and n. 12 (2001).").

75. *See* Selective Disclosure and Insider Trading, 65 Fed. Reg. 51716, 51738 (Aug. 24, 2000) (codified at 17 C.F.R. pt. 240 (2012)) (adopting, among other rules, Rule 10b5-2), Selective Disclosure and Insider Trading, 64 Fed. Reg. 72590, 72610 (Dec. 28, 1999) (to be codified at 17 C.F.R. pt. 240) (proposing, among other rules, Rule 10b5-2). *See generally* Donald C. Langevoort, *Brokers as Fiduciaries*, 71 U. PITT. L. REV. 439, 456 (2010) ("[D]ecisions . . . [should] . . . be made publicly and explicitly through rule-making. Simply placing the fiduciary label on the securities industry and leaving the rest to ad hoc decisions will produce a platform that is neither stable nor functional.").

76. *See* Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 982–83 (2005) ("Only a judicial precedent holding that the statute unambiguously forecloses the agency's interpretation, and therefore contains no gap for the agency to fill, displaces a conflicting agency construction.").

77. *See* United States v. O'Hagan, 521 U.S. 642, 660 (1997) (noting that the statute does not refer to "identifiable purchasers or sellers of securities").

78. *See generally In re* Cady, Roberts & Co., 40 S.E.C. 907, 915 (1961) ("The absence of a remedy by the private litigant because of lack of privity does not absolve an insider from responsibility for fraudulent conduct."); Donald C. Langevoort, *Words from on High about Rule 10b-5:* Chiarella*'s History,* Central Bank*'s Future*, 20 DEL. J. CORP. L. 865, 881 n.89 (1995) (implying that the misappropriation theory is not precluded by the text of the statute).

79. *But see* FCC v. NextWave Personal Commc'ns, Inc., 537 U.S. 293, 305 (2003) (criticizing the use of "ever-available snippets of legislative history").

obligations.[80] Reportedly, Congress never acted on such proposals—not because the bills would have imposed liability based on a breach of contract, but because of disagreement regarding the imposition of liability based on *mere possession* of inside information coincident to the troubling trade, as opposed to *actual use* of inside information in effecting a trade.[81] Though the evidence does not incontrovertibly establish that Congress actually approves of a contractually imposed duty underlying a violation of § 10(b),[82] the evidence hardly suggests that Congress precluded the Commission from promulgating such a rule.

Confronted with a statute that prohibited deception but did not state whether silence could be deceptive,[83] the Court reasonably determined that silence could not be deceptive absent a duty to disclose.[84] The BLS conclude that the Court's interpretation eliminates any statutory ambiguity and precludes any interpretive role for the Commission.[85] The Commission, however, acted within its rights in promulgating Rule 10b5-2(b)(1); the BLS ignore the Court's administrative law precedent, and interpret the Court's securities law precedent too narrowly.

1. Consideration of the Court's Administrative Law Precedent

The BLS entitled the third section of their amicus brief filed with the Fifth Circuit as "The SEC's justification for expanding liability under § 10(b) and Rule 10b-5 cannot overturn Supreme Court precedent."[86] The premise that an agency overturns a court's decision is faulty, as the Court noted in *Brand X*:

> The dissent [argues] that allowing an agency to override what a court believes to be the best interpretation of a statute makes "judicial decisions subject to reversal by executive officers." It does not. Since *Chevron* teaches that

80. *See* S. 1380, 100th Cong. §2 (1987) ("[I]nformation shall have been used or obtained wrongfully only if . . . by . . . misappropriation or a breach of any fiduciary, *contractual*, employment, personal, or other relationship of trust and confidence.") (emphasis added).

81. *See* Karmel, *supra* note 15, at 100. *See generally* 17 C.F.R. § 240.10b5-1 (2012).

82. For example, subsequent legislation carries more weight than does subsequent legislative history. *Compare* Red Lion Broad. Co. v. FCC, 395 U.S. 367, 380–81 (1969) ("Subsequent legislation declaring the intent of an earlier statute is entitled to great weight in statutory construction."), *with* Consumer Prod. Safety Comm'n v. GTE Sylvania, Inc., 447 U.S. 102, 118 n.13 (1980) ("A mere statement in a conference report of such legislation as to what the Committee believes an earlier statute meant is obviously less weighty.").

83. *See* Chiarella v. United States, 445 U.S. 222, 226 (1980) ("[Section] 10(b) does not state whether silence may constitute a manipulative or deceptive device.").

84. *See* Basic Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1988) ("Silence, absent a duty to disclose, is not misleading under Rule 10b-5.").

85. BLS' Appellate Brief, *supra* note 13, at 23.

86. *Id.* at 22.

> a court's opinion as to the best reading of an ambiguous statute an agency is charged with administering is not authoritative, the agency's decision to construe that statute differently from a court does not say that the court's holding was legally wrong. Instead, the agency may, consistent with the court's holding, choose a different construction, since the agency remains the authoritative interpreter (within the limits of reason) of such statutes. In all other respects, the court's prior ruling remains binding law (for example, as to agency interpretations to which *Chevron* is inapplicable). The precedent has not been "reversed" by the agency, any more than a federal court's interpretation of a State's law can be said to have been "reversed" by a state court that adopts a conflicting (yet authoritative) interpretation of state law.[87]

Consequently, the Commission's adoption of a rule that interprets an ambiguous statute differently than had a court on a prior occasion does not amount to the agency's overturning a judicial decision. Deference to the agency is due, despite a court's interpretation of the ambiguity that precedes and differs from the agency's interpretation.[88] Thus, a court's holding that silence could not constitute a violation of § 10(b) absent the breach of a fiduciary (or similar) duty does not preclude the Commission from promulgating a differing, but reasonable, rule resolving the statutory ambiguity.

The logic undergirding the Court's analysis in *Brand X* applies to a situation involving a prior interpretation of statutory ambiguity by the Court that conflicts with an agency's subsequent reasonable interpretation. That is, earlier Court precedent that interprets statutory ambiguity and requires the breach of a fiduciary (or similar) duty for a violation of § 10(b) should not preclude the Commission from interpreting the ambiguity differently. Some, however, might distinguish *Brand X*, because the subsequent agency decision conflicted with a lower court's decision, not Supreme Court precedent.[89] Therefore, one should examine whether Supreme Court precedent

87. Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 983–84 (2005) (citation omitted).

88. *See id.* at 982–83; Morrison v. Nat'l Austl. Bank, LTD, 130 S. Ct. 2869, 2889 (2010) (Stevens, J., concurring) (noting that the Commission never acted to change court-created common law); Tellabs, Inc. v. Makor Issues & Rights, LTD, 551 U.S. 308, 332 (2007) (Scalia, J. concurring in the judgment) (noting that discretion is "conferred upon administrative agencies, which need not adopt what courts would consider the interpretation most faithful to the text of the statute, but may choose some other interpretation, so long as it is within the bounds of the reasonable").

89. *Brand X*, 545 U.S. at 979.

precludes the Commission's interpretation as forged in Rule 10b5-2(b)(1).

2. Consideration of the Court's Securities Law Precedent

Despite Supreme Court precedent repeatedly describing the breach of a fiduciary (or similar) duty before silence can be deceptive under § 10(b), the precedent does not preclude the Commission from promulgating Rule 10b5-2(b)(1). Because the Court repeatedly resolved cases involving fiduciaries, it repeatedly described a fiduciary duty as the source of the duty to disclose. In *Basic, Inc. v. Levinson*, the culpable defendants were insiders of the corporation (who tipped outsiders),[90] and thus, fiduciaries of the deceived selling shareholders. In *O'Hagan*, the culpable defendant was an attorney associated with the law firm representing the deceived party,[91] and thus, a fiduciary. In *Chiarella v. United States*, the culpable defendant was an agent associated with the printer working on behalf of the deceived party,[92] and thus, a fiduciary.[93] In *Affiliated Ute Citizens v. United States*, the culpable defendants were broker–dealers,[94] who, in certain circumstances, are subject to fiduciary duties.[95] In *Dirks v. SEC*, the defendant was neither culpable nor a fiduciary, but the Court emphasized that he did not enter a confidentiality agreement with the source, nor did he misappropriate information.[96] Despite the Court's repeated descriptions of the breach of fiduciary duty as the source of the

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90. *See Basic*, 485 U.S. at 227 n.2; Brief for Respondents, Basic, Inc. v. Levinson, 485 U.S. 224 (1988) (No. 86-279), 1987 WL 881063, at *24 n.9.

91. *See* United States v. O'Hagan, 521 U.S. 642, 647–48 (1997).

92. *See* Chiarella v. United States, 445 U.S. 222, 224 (1980).

93. *See, e.g.*, RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) ("Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act."); Macey, *supra* note 10, at 41 ("The presence or absence of a fiduciary duty should be viewed as a consequence of a contractual relationship between the firm and another party.").

94. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 151–52 (1972).

95. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 913, 124 Stat. 1376, 1828 (2010); THOMAS LEE HAZEN, BROKER–DEALER REGULATION IN A NUTSHELL §53, at 154–55 (2003); Langevoort, *supra* note 75, at 442 (stating that courts, regulators, and broker–dealers themselves have been "working hard to try to turn the brokerage industry into something better than the retail mattress or shoe business"). *But see* Dirks v. SEC, 463 U.S. 646, 665 n.26 (1983).

96. *See Dirks*, 463 U.S. at 654 (noting that a duty to disclose arises from a fiduciary relationship); *id.* at 648 (noting that the defendant had no contractual or other relationship with the corporate source); *id.* at 665 ("[The defendant] took no action, directly or indirectly, that induced the shareholders or officers of Equity Funding to repose trust or confidence in him. There was no expectation by [his] sources that he would keep their information in confidence. Nor did [the defendant] misappropriate or illegally obtain the information about Equity Funding.").

duty to disclose, "such descriptions are just that—descriptive."[97] Section 10(b) says nothing about fiduciary duty, so requiring a breach thereof misses the mark.[98] "'Fiduciary duties' are a questionable basis on which to distinguish insiders from others."[99]

Nothing in *Dirks*, or any other Supreme Court precedent, precludes the requisite duty from being imposed by contract. To the contrary, when discussing the breach of a fiduciary duty, the Court has employed language applicable—without stretch or strain—to the breach of a confidentiality agreement. Regarding the obligations of corporate outsiders, the Court wrote:

> The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes. . . . For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.[100]

A corporate source agrees to disclose confidential information under a confidentiality agreement "for corporate purposes," not for altruistic reasons benefitting the confidant to the detriment of the source. What better way to set forth the corporation's "expectations" regarding confidentiality than an express agreement? If the relationship "at least must imply" a duty of confidentiality, then why could an agreement not expressly impose such a duty? Although the Court also referenced "special" relationships, perhaps suggesting that simple contractual relationships are not special, the Court dealt with *implied* obligations. So, while it may be inappropriate to *imply* the requisite duty in a simple contractual relationship, neither § 10(b) nor Court precedent precludes the breach of a contractually imposed duty as forming the basis for a § 10(b) violation.

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97. United States v. Stevens, 130 S. Ct. 1577, 1586 (2010).

98. *See* SEC v. Dorozhko, 574 F.3d 42, 48–49 (2nd Cir. 2009); *see also* United States v. Chestman, 947 F.2d 551, 557 (2nd Cir. 1991) ("[SEC's] Rule 14e-3(a) . . . creates a duty in those traders who fall within its ambit to abstain or disclose, without regard to whether the trader owes a pre-existing fiduciary duty to respect the confidentiality of the information.").

99. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 269 (1991).

100. *Dirks*, 463 U.S. at 655 n.14; *see* Chiarella v. United States, 445 U.S. 222, 227 (1980) (embracing the position that the requisite duty underlying § 10(b) culpability could arise from "the existence of a relationship affording access to inside information intended to be available only for a corporate purpose").

Deception is what § 10(b) requires,[101] and the breach of a fiduciary duty is simply one means of establishing deception; it is not the exclusive means of doing so.[102] Counseling against the requirement of a fiduciary duty as the exclusive source of a duty to disclose is the Court's own caution against using "rigid classifications" with respect to securities fraud.[103] It merits mention that, in this setting, the Court refers to a fiduciary *or similar* duty, indicating that silence could be deceptive in nonfiduciary settings.[104] Additionally, the Court cited the Restatement (Second) of Torts as authority for its position that a defendant's silence, while subject to a fiduciary duty, can constitute deception in a securities trade; but the Restatement *also* provides that silence can be deceptive in nonfiduciary settings.[105] Because the Court has dealt with fiduciaries, it has not been required to address silence-as-deception by nonfiduciaries, which hardly precludes the Commission from filling the statutory gap. One is "feigning fidelity"[106] to the source when, after agreeing to safeguard information and without disclosure of the breach, one breaches either an implied fiduciary duty of confidence or a contractually imposed duty of confidence.[107]

101. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473–74 (1977).

102. *See id.* at 474–75 (holding that an alleged fiduciary breach that is not coupled with an alleged omission or misstatement cannot constitute deception or manipulation); *Dorozhko*, 574 F.3d at 49 ("[W]hat is sufficient is not always what is necessary . . . ."); *id.* at 50 ("In its ordinary meaning, 'deceptive' covers a wide spectrum of conduct involving . . . trading in falsehoods."); United States v. Carpenter, 791 F.2d 1024, 1029 (2d Cir. 1986) ("Although *Dirks* disapproved of certain trading by insiders or quasi-insiders who owe a fiduciary duty to investors, courts are not thereby constrained from recognizing other misconduct. To give *Dirks* such preclusive effect would suggest that one application of a statute cannot admit of another application not raised in the first case."); Karmel, *supra* note 15, at 97 ("There is a difference between interpreting a broad or ambiguous statute or rule by referring to the common law, and holding . . . that a statute and rule is limited by the common law. Congress passed broad, remedial securities legislation, like the Exchange Act, in order to make the public securities markets fair and equitable because of the inadequacies in the common law.").

103. *See Dirks*, 463 U.S. at 653 (citing *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961)); *Cady, Roberts*, 40 S.E.C. at 912. *See generally* United States v. O'Hagan, 521 U.S. 642, 659 (1997) (rejecting rigid classifications of defendants: "it makes scant sense to hold a lawyer like O'Hagan 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."); *Chiarella*, 445 U.S. at 249 (Blackmun, J., dissenting) (rigid classification).

104. *Chiarella*, 445 U.S. at 228 ("[F]iduciary or other similar relation of trust and confidence . . . .").

105. *See id.* at 247–48 (Blackmun, J., dissenting); Langevoort, *supra* note 78, at 872 n.30 ("The Court's [*Chiarella*] opinion reads as if the Restatement (Second) of Torts supports its restriction of the duty to disclose to fiduciary relationships. In fact, as Justice Blackmun's dissent discusses, the Restatement (Second) of Torts (and the common law generally) support a broader duty to disclose.") (citations omitted).

106. *O'Hagan*, 521 U.S. at 655.

107. For example, when interpreting the mail fraud statute, the Court determined that misappropriation of information contrary to a confidentiality agreement constitutes deception.

C. *Reasonable Interpretation of Statutory Ambiguity*

Courts enforce reasonable agency-promulgated rules, not those that are arbitrary and capricious.[108] The litigant who challenges the validity of an agency's rule bears the burden of establishing that the rule is arbitrary and capricious.[109] Because portions of the forgoing analysis suggest that Rule 10b5-2(b)(1) is reasonable, the following subsections highlight a few areas emphasized by the Court.

1. Consistency

Courts accord deference to consistently applied, long-standing agency positions.[110] The Commission's position regarding Rule 10b5-2(b)(1) has been consistent. No evidence has been located that the Commission previously claimed that the breach of a confidentiality agreement could *not* constitute deception under § 10(b). For decades, the Commission has advocated that the breach of a confidentiality agreement could constitute deception. Moreover, the Commission's long-standing position is consistent with long-standing common law.[111]

In a 1961 administrative action, the Commission disciplined a corporate insider, who was subject to fiduciary duties, for insider

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See Carpenter v. United States, 484 U.S. 19, 27 (1987) ("The concept of 'fraud' includes the act of embezzlement, which is 'the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another.'") (citing Grin v. Shine, 187 U.S. 181, 189 (1902)); *Carpenter*, 484 U.S. at 28 (holding that conduct is fraudulent when, contrary to a duty of confidentiality, one appropriates confidential information "all the while pretending to perform his duty of safeguarding it").

108. *See* 5 U.S.C. § 706(2)(A) (2006).

109. *See* City of Olmsted Falls v. FAA, 292 F.3d 261, 271 (D.C. Cir. 2002) ("The party challenging an agency's action as arbitrary and capricious bears the burden of proof.") (quoting Lomak Petroleum, Inc. v. FERC, 206 F.3d 1193, 1198 (D.C. Cir. 2000)). *But see* Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 43 (2003) (arguing for a presumption against the Commission's regulatory intervention) ("[M]onopolistic regulators should face a stronger presumption against intervention than regulators facing competition.").

110. *See* Alaska Dep't. of Envtl. Conservation v. EPA, 540 U.S. 461, 487 (2004); Barnhart v. Walton, 535 U.S. 212, 220 (2002); *see also* Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944) (linking persuasiveness to agency interpretations that are long-standing and consistently applied). An agency position, however, need not be long-standing to benefit from *Chevron* deference; otherwise, ossification of the law could result. *See* Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 853–59, 865–66 (1984).

111. *See* Reply Brief of the SEC, Appellant, with Citations to Deferred Joint Appendix at 14, SEC v. Sargent, 229 F.3d 68 (1st Cir. 2000) (No. 00-1293) [hereinafter SEC Brief] ("This is merely in keeping with the long-standing common law doctrine that a person may assume a fiduciary duty by voluntarily accepting the confidence of another.") (collecting cases). *See generally* 4 GEORGE E. PALMER, THE LAW OF RESTITUTION § 19.2, at 104–05 (1978) ("In the oral trust situation, . . . the grantee usually was guilty of no wrong in accepting title to hold in trust for the grantor . . . . His wrong occurs after the transfer and consists of his breach of the confidence reposed in him.").

trading; however, in so doing, the Commission specifically stated that its position applied beyond corporate insiders.[112] Relationships that could give rise to culpability include those "giving access . . . to information intended to be available only for a corporate purpose and not for the personal benefit"[113] of the confidant. Though the Commission did not expressly reference confidentiality agreements, its stated position would apply to such agreements, and presaged a position that would more fully develop over time. In the 1980s, 1990s, and 2000s, prior to the adoption of Rule 10b5-2(b)(1), the Commission articulated its position that the breach of a confidentiality agreement could constitute deception that violated § 10(b).

In 1985, the Commission—as amicus in a criminal prosecution—supported the position that "[t]he origin of the confidence . . . [is] immaterial."[114] In *United States v. Reed*, a son betrayed his father by trading on material, nonpublic information that the father disclosed to the son. Despite the absence of any reliance by the father on the son as a fiduciary, and despite the absence of an agreement between the two, the court accepted the Commission's position that the requisite deception could be inferred due to the pair's history of shared confidences.[115] In *Reed*, the court recognized an obligation owed to the source of information that was not embodied in an express agreement, and accepted the Commission's position that the obligation that the defendant owed to the source could be based upon "an agreement . . . of confidentiality, express or implied."[116] The Commission has long advocated that the defendant may voluntarily subject himself to the requisite duty through a confidentiality agreement, in light of the uncertainty that attends a court's *ex post*, ad hoc implication of the requisite duty. The Court has referenced the value of certainty in the regulation of securities.[117]

In a criminal prosecution from the 1990s, where the Commission and the Department of Justice jointly signed a brief, the Commission repeated its position that a confidentiality agreement could impose the requisite duty of confidentiality that, if breached, could result in a violation of § 10(b) for insider trading.[118] The Commission's brief

112. *See In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).

113. *Id.*

114. United States v. Reed, 601 F. Supp. 685, 707 (S.D.N.Y. 1985).

115. *See id.* at 709. No dominance or superiority is required when there is an express promise of fidelity. *See id.* (citing PALMER, *supra* note 111, §§ 19.2–.4, at 95–134).

116. *Reed*, 601 F. Supp. at 718; *id*. at 717 ("[E]ven in the absence of an express agreement, it properly may be determined that a confidential relationship existed . . . .").

117. *See* Dirks v. SEC, 463 U.S. 646, 658 n.17 (1983) ("Unless the parties have some guidance as to where the line is between permissible and impermissible disclosures and uses, neither corporate insiders nor analysts can be sure when the line is crossed.").

118. Brief for the United States at 27, United States v. Chestman, 947 F.2d 551 (2d Cir.

phrased the issue as "[whether the defendant was] bound by an agreement or understanding of confidentiality, express or implied, . . . that . . . generated . . . a justifiable expectation of confidentiality and fidelity."[119] The en banc court accepted the Commission's position that breaching a confidentiality agreement could constitute deception and form the basis of an enforcement action under § 10(b).[120]

In a 1990 enforcement action, the Commission set forth its position that the requisite deception in a misappropriation case could be founded upon the breach of an agreement between occupants of neighboring businesses regarding the handling of mail.[121] According to the Commission, Bruce Warren breached a duty of trust and confidence to his neighbor when he opened a letter addressed to the neighbor that was marked "personal and confidential," then provided a tip to an individual who traded on the basis of the material, nonpublic information contained therein.[122]

In 2000, shortly before the adoption of Rule 10b5-2(b)(1), the Commission again advocated its position that a confidentiality agreement could impose the requisite duty to the source of material, nonpublic information.[123] In the Commission's enforcement action against Michael Sargent, Dennis Shephard, and Robert Scharn, the source had informed a confidant that the information should not be disclosed to anyone else, and the confidant had assured the source that he would not disclose it.[124] The court accepted the Commission's position that the defendant's culpability could rest upon "a promise by the misappropriator that the information would be safeguarded."[125]

The Commission's long-standing consistency in its position supports an inference of congressional acceptance of that position. When Congress repeatedly amends a statute, in the face of a long-standing agency position, without upsetting the agency's position, such

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1991) (No. 89-1276).

119. *Id.* (quoting *Reed*, 601 F. Supp. at 718).

120. *See Chestman*, 947 F.2d at 571 ("Keith's status as Susan's husband could not itself establish fiduciary status. Nor, absent a pre-existing fiduciary relation or *an express agreement of confidentiality*, could the coda—'Don't tell.'") (emphasis added).

121. *See* Litigation Release No. 12338, SEC v. Pencikowski, 45 SEC Docket 381 (Jan. 8, 1990).

122. *See id.* at 381–82; 18 DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT, AND PREVENTION § 6.04[2], at 6-21 n.22 (1991).

123. *See* SEC Brief, *supra* note 111, at 21.

124. *See id.*; SEC v. Sargent, 229 F.3d 68, 71 (1st Cir. 2000) ("Aldrich told Shepard that this fact needed to be kept confidential and Shepard agreed not to disclose the information.").

125. *Sargent*, 229 F.3d at 75 ("[T]he existence of a fiduciary relationship turns on whether the source of the misappropriated information granted the misappropriator access to confidential information in reliance on a promise by the misappropriator that the information would be safeguarded.").

congressional inaction regarding the agency's position lends credence to that position, and favors judicial deference.[126] Congress has amended the Exchange Act both since the Commission set forth its position informally,[127] and since the Commission formally promulgated Rule 10b5-2(b)(1).[128] That rule commands judicial deference.

2. Consideration of Regulatory Alternatives

Chevron deference also hinges on the importance of the issue being administratively enforced.[129] The Commission relies heavily upon § 10(b) (including Rule 10b-5 promulgated thereunder), leading some to refer to that tandem as the "workhorse for securities fraud prevention."[130] Enforcement by the Commission may be critical in misappropriation cases because viable alternatives are scarce. Although courts link *Chevron* deference to the thoroughness of the agency's deliberation, and an agency's thorough deliberation would include consideration of alternatives to its chosen regulatory rule, courts should be mindful of their limited role. Otherwise, courts run the risk, when examining regulatory alternatives, of undertaking inquiries like "whether the agency should regulate at all" and "whether the agency should have chosen a different means of regulation," which are not for the court,[131] and which are beyond the scope of this Article.[132]

Despite the court's limited role, some alternatives to Rule 10b5-2(b)(1) are addressed here. For example, criminal prosecution presents one alternative, but many prefer civil public enforcement to criminal public enforcement.[133] Even if Rule 10b5-2(b)(1) provides some

126. *See* Merrill Lynch v. Dabit, 547 U.S. 71, 85 (2006); Barnhart v. Walton, 535 U.S. 212, 220 (2002).

127. *See* Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988); Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 2, 98 Stat. 1264 (1984) (authorizing the Commission to seek three times the gain or loss avoided).

128. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 763, 124 Stat. 1376, 1762 (2010); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 1106, 116 Stat. 745, 810 (2002).

129. *See Barnhart*, 535 U.S. at 222; Brookings Mun. Tel. Co. v. FCC, 822 F.2d 1153, 1169 (D.C. Cir. 1987) (noting that an agency has a "duty to consider responsible alternatives").

130. Lisa Schultz Bressman & Robert B. Thompson, *The Future of Agency Independence*, 63 VAND. L. REV. 599, 641 (2010); *see also* David M. Brodsky & Daniel J. Kramer, *A Critique of the Misappropriation Theory of Insider Trading*, 20 CARDOZO L. REV. 41, 45 (1998) ("[S]ection 10(b) and Rule 10b-5 have become the primary provisions for prosecuting insider trading.").

131. *See* Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs, 545 U.S. 967, 982–83 (2005); Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842–44 (1984).

132. *See supra* note 16 and accompanying text.

133. *See generally* Larry E. Ribstein, *The Perils of Criminalizing Agency Costs*, 2 J. BUS. & TECH. L. 59 (2007) (discussing the negative ramifications of subjecting corporate agents to criminal penalties); Christine Hurt, *The Undercivilization of Corporate Law*, 33 J. CORP. L. 361,

certainty, the general uncertainty that attends the regulation of insider trading may counsel against criminal prosecution.[134]

Some prefer the states to the federal government when it comes to regulating securities,[135] but Congress has acted contrary to such preferences by creating a federal regulatory regime,[136] by preempting state regulation in certain areas,[137] and going so far as to use the federal regulation of securities to encroach on matters of corporate law, which traditionally has been an area of state regulation.[138] Congress emphasized the applicability of federal law to insider trading and enhanced the Commission's authority regarding insider trading.[139] Moreover, Congress has suggested that its regulations apply to the misappropriation theory of insider trading.[140]

369–71 (2008) (same).

134. *See* Langevoort, *supra* note 33, at 1622 (noting the incoherence of insider-trading law and attributing that incoherence, in part, to its development over time through individual enforcement actions). *See generally* Crandon v. United States, 494 U.S. 152, 158 (1990) ("[I]t is appropriate to apply the rule of lenity in resolving any ambiguity in the ambit of the statute's coverage.").

135. *See* ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION 48–49 (2002); Larry E. Ribstein, *Federalism and Insider Trading*, 6 SUP. CT. ECON. REV. 123, 125 (1998) ("State law already offers better-developed legal rules regarding property rights.").

136. *See, e.g.*, 15 U.S.C. § 78d (2006) (creating the Commission); *id.* § 78aa (creating exclusive federal jurisdiction for matters arising under the Exchange Act).

137. *See id.* § 77r(a). *But see id.* §§ 78bb(a), (f).

138. *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L. J. 1521, 1523 (2005); Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1783–84 (2011). In limited areas, Congress has precluded enforcement by state entities. *See* 15 U.S.C. § 77r(a) (2006). The argument that an unsupervised federal agency has wrongfully infringed on the states' domain loses force when the agency's position is long-standing. The Commission's position set forth in Rule 10b5-2(b)(1) is long-standing. *See supra* Subsection II.C.1.

139. *See* Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988); Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 2, 98 Stat. 1264 (1984) (authorizing the Commission to seek three times the gain or loss avoided).

140. *See* H.R. REP. NO. 100-910, at 10 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6047 ("Under current case law, the SEC must establish that the person misusing the information has breached either a fiduciary duty to shareholders or some other duty not to misappropriate insider information."); H.R. REP. NO. 100-910, at 26 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6063 ("[T]he codification of a right of action for contemporaneous traders is specifically intended to overturn court cases which have precluded recovery for plaintiffs where the defendant's violation is premised upon the misappropriation theory."); H.R. REP. NO. 98-355, at 4–5 (1984), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2277–78 ("[C]onversion for personal gain of information lawfully obtained abuses relationships of trust and confidence and is no less reprehensible than the outright theft of nonpublic information. In other areas of the law, deceitful misappropriation of confidential information by a fiduciary . . . has consistently been held to be [criminal]. The Congress has not sanctioned a less rigorous code of conduct [for civil matters] under the federal securities laws.") (citation omitted).

We commonly turn to public enforcement when private enforcement is lacking.[141] So, does private enforcement suffer from any shortcomings? Private enforcement of misappropriation cases under § 10(b) of the Exchange Act will frequently fail. The deceived source often will not have purchased or sold securities, and would therefore lack standing under § 10(b).[142] Private misappropriation actions by third-party traders under § 10(b) may also be doomed for failure to establish reliance and causation.[143] Private enforcement by a class under state law may be precluded,[144] and individual actions may be cost-prohibitive.[145]

Instead of securities-based litigation, what about a simple contract claim for breaching the confidentiality agreement?[146] Proving a breach may be problematic; even if done, remedies may be lacking. The source of information faces tremendous difficulty in identifying how the confidential information entered the market or who is responsible for the leak. The one entrusted with information may have disguised her trades or surreptitiously tipped others about the information.[147] Such difficulties of detection lessen private enforcement, and counsel in favor of public enforcement, as the federal government possesses greater detection tools.[148] Multiple private parties—such as the source and a

141. Barack Obama, U.S. President, State of the Union Address (Jan. 24, 2012), *available at* http://www.whitehouse.gov/the-press-office/2012/01/24/remarks-president-state-union-address ("[G]overnment should do for people only what they cannot do better by themselves, and no more.") (crediting Abraham Lincoln).

142. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 738–39 (1975).

143. *See* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 152–53 (2006) (requiring private plaintiffs to establish reliance); Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336, 338 (2005) (requiring private plaintiff to establish loss causation).

144. *See* Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, § 101(b), 112 Stat. 3227, 3230 (1998); Merrill Lynch v. Dabit, 547 U.S. 71, 87–88 (2006).

145. *See* COX, *supra* note 3, at 747 ("[Because] most purchasers or sellers have relatively small amounts at stake . . . , the class action device is often the only economically viable means of achieving the compensatory and deterrent goals underlying the private action.").

146. *See* EASTERBROOK & FISCHEL, *supra* note 99, at 263 ("That no uniform rule is optimal implies that the subject is best left to negotiations between insiders (and others) and the firm. Courts would enforce actual contracts . . . .").

147. *See* JAMES B. STEWART, DEN OF THIEVES 68 (1991) ("Using codes was fun; it gave their insider-trading scheme the aura of a Hardy Boys escapade. Soon they were engaged in conversations so riddled with codes they would have seemed ludicrous to any listener."); Kara Scannell, *SEC Loss Shows Difficulty of Insider Cases*, WALL ST. J., June 28, 2010, at C1 (showing that insider trading is notoriously difficult to detect when intelligent individuals attempt to shield their actions).

148. *See* EASTERBROOK & FISCHEL, *supra* note 99, at 263 ("[T]he difficulty of enforcing such contracts makes it impossible for firms to achieve optimal allocations of the rights. Insiders' trades are notoriously hard to detect . . . . If firms seeking to curtail inside trading by contract cannot enforce their choices, then the benefits are lost. . . . If the probability of detecting improper trades is low, public enforcement may be best."); Macey, *supra* note 10, at 46 n.185 ("[T]he cost to the firm of insuring that managers do not abuse their right to trade may

self-regulatory organization, such as a stock exchange—may monitor the same subject. Duplicative private enforcement may contribute to underenforcement,[149] as each monitor allocates fewer resources to monitoring the confidant on the mistaken belief that another monitor will continue its vigilance. A single public enforcer may be superior.[150]

Remedies for breach may be inadequate. The potential for profit may incentivize contract breaches, which, if detected, may be underdeterred by a simple damages claim.[151] The risk of reputational harm may prevent some parties from breaching a confidentiality agreement, but reputational harm provides far less discipline for nonrepeat players. Although the public eventually would have learned of Cuban's trades, the public might not have learned of the confidentiality agreement (which was an oral agreement[152]) or its breach. For some, such as Cuban, reputational harm may not jeopardize future opportunities to a degree that adequately disciplines them for their breaches. Mark Cuban has billions of dollars to invest, and he earned his money through his technological savvy. Because of his money and experience, Cuban probably would be presented with opportunities, even if he were known to have breached a confidentiality agreement. Recognizing that private remedies may be inadequate, Congress bolstered the remedies that the government may seek.[153]

It is no secret that post-disclosure private remedies are inadequate for the breach of a confidentiality agreement. A confidentiality agreement itself reflects the shortcomings of post-disclosure remedies. Confidentiality agreements typically provide for specific performance because of the difficulty of determining damages. Moreover, confidentiality agreements also require that the confidant provide notice to the source prior to any potential compelled disclosure. The notice provision allows for the possibility of the source obtaining a protective

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raise the cost of transacting, thereby making it more efficient for the firm to ban such trading.").

149. *Cf.* Macey, *supra* note 10, at 59 (noting that reliance on private enforcement "may result in a suboptimal level of enforcement").

150. *Compare* EASTERBROOK & FISCHEL, *supra* note 99, at 263, *with* Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 565 (1970) ("I do not believe [the SEC's] enforcement techniques are nearly as good as they say . . . .").

151. *See* Macey, *supra* note 10, at 59. *See generally* EASTERBROOK & FISCHEL, *supra* note 99, at 260. Moreover, the expected gain may exceed the expected loss, due to the low likelihood of detection. By allegedly trading on inside information, Martha Stewart risked millions and incarceration to avoid the loss of a relatively nominal sum. *See* Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1044 (Del. 2004) (referencing plaintiff's claim that Stewart's illegal trades jeopardized the company's financial future); Litigation Release No. 18169, SEC v. Stewart, 80 SEC Docket 1244 (June 4, 2003) (discussing allegations against Stewart, whose trades avoided the loss of less than $50,000).

152. *See* Complaint, *supra* note 3, at 4.

153. *See* Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 2, 98 Stat. 1264 (1984) (authorizing the Commission to seek three times the gain or loss avoided).

order. Post-disclosure remedies may prove inadequate to discipline the breaching party.

A final alternative might be no regulation at all, as the market may discipline insider trading. First, in support of this alternative, long-term considerations might deter any potential improper short-term focus by insiders.[154] Second, a rule that allows insiders to trade might permit the source to compensate the insider more efficiently, by, for example, lowering annual salary in light of the insider's ability to trade profitably on material nonpublic information.[155] Counterarguments exist. Even if the threat of long-term costs *commonly* deters an individual from engaging in short-term misconduct, some individuals sacrifice long-term benefits for short-term gain.[156] A general truth need not prevent the promulgation of a rule designed to address *uncommon* behavior. (And, of course, such uncommon behavior may be far more common than realized.) Aware of the consequences of such long-term for short-term trade-offs, the government may regulate private parties' compensation schemes. One recent example follows. In the Sarbanes–Oxley Act of 2002, Congress prohibited businesses from compensating their accountants in certain ways because of externalities.[157] Accountants at Arthur Andersen LLP helped fell the firm because their compensation scheme led them to compare their personal benefits and costs, ignoring third-party costs, even though those costs were leviathan.[158] The impact of the accountants' misdeeds reached well beyond themselves,

154. *See* MANNE, *supra* note 16, at 148–51.

155. *See id.* at 138.

156. *See* John R. Graham et al., *The Economic Implications of Corporate Financial Reporting*, 40 J. ACCT. & ECON. 3, 5–6 (2005); Michael C. Jensen, *Agency Costs of Overvalued Equity*, 34 FIN. MGMT. 5, 14–15 (2005); Langevoort, *supra* note 33, at 1604.

157. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 201–03, 206, 116 Stat. 745, 773–775 (2002); *id*. § 402(a), 787 (prohibiting executives to be compensated through loans). In the Dodd–Frank Wall Street Reform and Consumer Protection Act, Congress responded to criticisms of the excesses of executive compensation by empowering shareholders of certain corporations to have a "say on pay." *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899 (2010). *See generally* LUCIAN A. BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004) (describing the excesses of executive compensation and discussing managerial influence over executive compensation).

158. *See* Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1239 (2002) ("The previous paragraphs addressed the independence of Andersen as a firm, but of course services were delivered by specific agents of the firm, its Houston partners. It now seems that the compensation of the Houston partners was significantly tied to their client billings both for auditing services and for consulting services. Enron might have been a relatively small client for Andersen, the firm, but it was the largest client for its Houston office, and, for the Enron relationship partners, perhaps their only significant client. . . . The disparity between the value of the Houston partners' share of Andersen's reputation and the value to them of a continued (or more lucrative) Enron client relationship sets up an obvious moral hazard problem.").

impacting the credibility of the entire firm, and placing in question the imprimatur of other accounting firms.[159] Allowing insider trading could incentivize valuable innovation, but such a rule need not yield an efficient compensation scheme, as insiders could profit on the innovations of others.[160] This scenario was precisely the case in *O'Hagan*, where the Court embraced the misappropriation theory. O'Hagan exhibited no entrepreneurial skill in creating the valuable, nonpublic information on which he traded.[161]

Though some reasonably prefer alternatives to federal regulation of the misappropriation theory, those alternatives face reasonable criticisms. The Commission can choose among reasonable regulatory alternatives.

3. Internal Inconsistency

Courts have struck down agency-promulgated rules as arbitrary and capricious when those rules are internally inconsistent.[162] Perhaps Rule 10b5-2(b)(1) should fall, as the rationale underlying the misappropriation theory is internally inconsistent. The misappropriation theory serves, in part, to protect market integrity, but the theory allows that protection to be circumvented as next described. To protect the integrity of the secondary markets, we will not allow a misappropriating confidant to trade on misappropriated information, because other traders in the market could not, by the sweat of their brow, have obtained the same information.[163] The misappropriation theory, however, permits the confidant to trade on that information if he admits to the source his intention to trade, because the source would, in that instance, not be deceived.[164] Even if the source is not deceived, other traders in the market will continue to be unaware of the material, nonpublic information, and those other traders still could not have gathered the information by expending their best efforts. The misappropriation theory, designed to enhance market integrity, can operate to undermine

159. *See id.*; A.C. Pritchard, *The Irrational Auditor and Irrational Liability*, 10 LEWIS & CLARK L. REV. 19, 26 (2006).

160. *See* MANNE, *supra* note 16, at 156–58.

161. *See* United States v. O'Hagan, 521 U.S. 642, 647 (1997); MANNE, *supra* note 16, at 131–45 (discussing the entrepreneur's compensation).

162. *See* Marsh v. Or. Natural Res. Council, 490 U.S. 360, 378 (1989).

163. *See O'Hagan*, 521 U.S. at 652–53, 658–59; Selective Disclosure and Insider Trading, 65 Fed. Reg. 51716, 51727 (Aug. 24, 2000) (codified at 17 C.F.R. pt. 240 (2012)) ("We have long recognized that the fundamental unfairness of insider trading harms not only individual investors but also the very foundations of our markets, by undermining investor confidence in the integrity of the markets."); *id.* at 51729 ("[T]he trader's informational advantage stems from contrivance, not luck, and the informational disadvantage to other investors cannot be overcome with research or skill.") (citation omitted) (internal quotation marks omitted).

164. *See O'Hagan*, 521 U.S. at 655.

it.[165] Such internal inconsistency could undermine the validity of Rule 10b5-2(b)(1).

Another internal inconsistency of the misappropriation theory is its foundation in property law. The theory is supported by the source's property rights in the information misappropriated by the confidant.[166] The misappropriation theory prohibits the confidant from exploiting the property of the source to the source's detriment. If the source truly has a property right in that information, then the source should be free *not* to protect that right; that is, the source should be free to opt out of the Commission's regulation of its property. This, however, the source cannot do.[167]

While these are sound arguments, they may not persuade the reader. The alternative to agency resolution of such disputes is resolution by the courts. In *O'Hagan*, the Supreme Court adopted the misappropriation theory; it was not persuaded that the theory was doomed by the aforementioned internal inconsistencies. Given the Court's adoption of the theory, the Commission need not abandon it.[168] Congress has suggested its support for the misappropriation theory,[169] indicating again that the Commission need not abandon it. Additionally, Congress has charged the Commission with balancing potentially competing interests.[170] At some level, the charge to protect investors may conflict with the charge to protect businesses' ability to raise capital. Given Congress' (potentially) internally inconsistent mandate, the Commission's rules may be internally inconsistent at some level, which should not doom deference.[171]

165. *See id.* at 689–90 (Thomas, J., dissenting).

166. *See id.* at 653–54; EASTERBROOK & FISCHEL, *supra* note 99, at 254 ("Better, then, to identify property rights in information."); Bainbridge, *supra* note 37, at 1644–50; Macey, *supra* note 10, at 18 n.47 ("Liability for 10b-5 violations is now founded on a theory . . . that finds its own roots in a 'business property theory' of insider trading liability."); *see also* Manne, *supra* note 150, at 549–51 (criticizing the property rights theory).

167. *See* 15 U.S.C. § 77n (2006) ("Any condition, stipulation, or provision binding any person . . . to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void.").

168. *Cf.* Morrison v. Nat'l Austl. Bank Ltd., 130 S. Ct. 2869, 2887–88 (2010) ("Since the Commission's interpretations relied on cases we disapprove, . . . we owe them no deference.").

169. *See supra* note 140 and accompanying text. *See generally* STOCK Act, S. 1903, 112th Cong. (2011) (prohibiting members of Congress and their staff from trading in securities based upon material nonpublic information learned through the course of their jobs); STOCK Act, S. 1871, 112th Cong. (2011) (same); STOCK Act, H.R. 1148, 112th Cong. (2011) (same). The Stock Act has since been enacted. *See* STOCK Act, Pub. L. No. 112-105, § 4, 126 Stat. 291, 292 (2012).

170. *See* 15 U.S.C. § 78c(f) (2006) ("Whenever pursuant to this chapter the Commission is engaged in rulemaking . . . the Commission shall also consider, in addition to the protection of investors, whether the action will promote . . . capital formation.").

171. *See* Golden State Bottling Co. v. NLRB, 414 U.S. 168, 181 (1973) (deferring to the agency when required to "strik[e] a balance between . . . conflicting legitimate interests"

Other attacks, not limited to the misappropriation theory, have been launched against the coherence of the theory prohibiting insider trading.[172] For example, federal securities laws generally, and the Commission's rules in particular, are designed to enhance efficiency.[173] A general attack on the prohibition of insider trading has been that information does not enter the market through insiders' trades, so that the share price does not accurately reflect material, nonpublic information; this distorts the cost of capital, and results in the inefficient allocation of resources.[174] This broad conception of efficiency suggests that insider trading should be permitted, so that material, nonpublic information enters the market more quickly.[175] Although this broad conception of efficiency (taking into account the interests of third parties[176]) counsels in favor of permitting insider trading, a narrow conception of efficiency counsels against insider trading (taking into account the interests of the parties to a confidentiality agreement). Contracts evidence the parties' values. A confidentiality agreement that prohibits the confidant's use of information for trading may be the best evidence of the efficient allocation of the source's information.[177] Rule 10b5-2(b)(1) embraces the efficient allocation by the parties to the confidentiality agreement (possibly at the expense of the market's overall efficient allocation of resources), and in furtherance of the Commission's market-integrity argument.[178] Even those who disfavor

because that balance is "often a difficult and delicate responsibility, which the Congress committed primarily" to the agency) (internal quotation marks omitted); EASTERBROOK & FISCHEL, *supra* note 99, at 283 ("[A] rule against fraud is not . . . essential . . . [but] certification methods [are] costly . . . . A rule against fraud can reduce these costs . . . .").

172. *See* Langevoort, *supra* note 33, at 1622 (attributing the incoherence of insider-trading law, in part, to its development over time through individual enforcement actions). *See generally id*. at 1610 (noting the internally inconsistent premises of securities regulation that (1) the typical investors are unsophisticated, and (2) those same investors will comprehend any mandated disclosure).

173. *See* 15 U.S.C. § 78c(f) (2006) ("Whenever pursuant to this chapter the Commission is engaged in rulemaking . . . the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency . . . .").

174. *Compare* Lisa K. Meulbroek, *An Empirical Analysis of Illegal Insider Trading*, 47 J. FIN. 1661, 1661 & n.1 (1992), *with* Gilson & Kraakman, *supra* note 10, at 631 (noting that an insider's trade has communicative value, but is not an efficient means of communication). *But see* Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75, 75, 78 (2002) ("[T]he cost of equity . . . decreases significantly after the first prosecution [under insider trading laws].").

175. *See* EASTERBROOK & FISCHEL, *supra* note 99, at 257; Manne, *supra* note 150, at 565–66.

176. *See* Manne, *supra* note 150, at 566 ("The gains from efficiency are diffuse and often specifically unidentifiable.").

177. EASTERBROOK & FISCHEL, *supra* note 99, at 259; Macey, *supra* note 10, at 46 n.185 ("[I]t may be . . . more efficient for the firm to ban such trading.").

178. 17 C.F.R. § 240.10b5-2(b)(1) (2012) (including agreements to maintain information in

the Commission's prohibition of insider trading acknowledge the benefit of the parties' private, efficient allocation regarding the information: "[W]hy . . . assume that anyone advocating no government rule against insider trading is necessarily saying that it may not be banned in a private contract?"[179] "[I]f . . . a corporation properly indicates that its rule is no insider trading, that should be the business of that corporation and its shareholders and the courts if a violation is alleged."[180]

4. Relative Institutional Expertise

Besides the standard arguments that favor judicial deference to an agency—such as a national rule that is uniform across all court jurisdictions[181] and the avoidance of regulatory ossification traceable to the stare decisis principle employed by courts[182]—courts defer to agencies due to their relative expertise.[183] Whereas courts generally resolve legal dilemmas lacking in precision—for example, *reasonable search* or *totality of the circumstances*—an agency may bring science to bear on certain dilemmas and offer precision ordinarily lacking in legal disputes, justifying judicial deference to the agency. We might prefer that, before a court defers to an agency, the agency undertake rigorous empirical analysis of the expected benefits of contemplated regulation in light of expected costs of that regulation.[184] Some contend that the

confidence within the enumerated "duties of trust and confidence").

179. Manne, *supra* note 150, at 580.

180. *Id.* at 581.

181. *Cf.* Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 847–48 (1984).

182. *See* SEC v. Capital Gains Res. Bureau, Inc., 375 U.S. 180, 194 (1963) ("[G]rowing 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.").

183. *See Chevron*, 467 U.S. at 865–66; Langevoort, *supra* note 78, at 868 ("[T]he Supreme Court speaks with very little expertise, and hence relatively less subject-matter authority, on intricate matters of federal regulation such as securities law."); *see also* SEC v. Zandford, 535 U.S. 813, 819–20 (2002) ("[The SEC's] interpretation of the ambiguous text of § 10(b), in the context of formal adjudication, is entitled to deference if it is reasonable, see *United States v. Mead Corp.*, 533 U.S. 218, 229–30, and n. 12 (2001)."); United States v. O'Hagan, 521 U.S. 642, 673 ("[Section] 14(e)'s rulemaking authorization gives the Commission 'latitude,' even in the context of a term of art . . . . [W]e must accord the Commission's assessment 'controlling weight unless it is arbitrary, capricious, or manifestly contrary to the statute.'").

184. *See* Business Roundtable v. SEC, 647 F.3d 1144, 1150 (D.C. Cir. 2011) ("[T]he Commission relied upon insufficient empirical data . . . ."); Manne, *supra* note 150, at 548 ("The debatable aspects of insider trading are capable of resolution through tools of economic analysis."); *id.* at 568 ("We must either utilize hard, accurate data or we should proceed on the assumptions dictated by the most logical economic doctrines."); Henry G. Manne, *Insider Trading and the Administrative Process*, 35 GEO. WASH. L. REV. 473, 510 (1967) [hereinafter

Commission's regulation of insider trading is not reasonable, and is perhaps arbitrary and capricious, because empirical analyses do not support—or worse, undermine—the rationales offered by the Commission.[185] Some contend that the Commission frequently accords little weight to such empirical evidence,[186] and instead runs to fuzzy notions of fairness, investor protection, and market integrity to justify its regulatory efforts.[187]

Despite the strength of these arguments, the Commission's rule is reasonable. First, although the Commission may rely on fuzzy notions, those same fuzzy notions motivated Congress to increase the Commission's powers to deter insider trading.[188] Additionally, those same fuzzy notions have motivated decisions by the Court.[189] Second,

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Manne, *Administrative Process*] ("[I]n an area like insider trading . . . [,] empirical data and rigorous economic analysis would be . . . desirable.").

On a related note, systematic evidence is preferred to anecdotal evidence. Anecdotes, however, frequently prompt legislation by Congress. For example, the Sarbanes–Oxley Act was prompted by the accounting scandals at WorldCom and Enron. *See* Rich Karlgaard, *America's 12-Step Program*, FORBES, Jan. 17, 2011, at 24. Anecdotes need not be ignored by the Commission, and a single anecdote may justify a regulation, depending on its magnitude and the likelihood of its recurrence.

185. *See* Meulbroek, *supra* note 174, at 1661, 1696.

186. *See generally* Choi & Pritchard, *supra* note 109, at 30 ("Evidence that does not discredit regulation unambiguously will be ignored. And the . . . bias will be more pronounced if the evidence is more complex and subject to conflicting inferences, a fair characterization of most regulatory problems in the securities markets.") (citations omitted).

187. *See id.* at 33 ("The SEC often uncritically states that it seeks to protect investors—and in particular, that absent the SEC's efforts, investor confidence in the market will deteriorate. Rarely, however, does the SEC verify that its assumptions are correct. The SEC instead simply asserts that investor confidence demands its latest regulatory intervention."); Manne, *Insider Trading and the Administrative Process*, *supra* note 184, at 506 ("[A] simple allegation of unfairness [should not] be allowed as a substitute for research and analysis . . . [and] does not meet the standards which are required for the exercise of administrative expertise.").

188. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264, 1264 (1984); H.R. REP. NO. 98-355, at 2 (1984), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2275 ("Capital formation and our nation's economic growth and stability depend on investor confidence in the fairness and integrity of our capital markets. Insider trading threatens these markets by undermining the public's expectations of honest and fair markets . . . ."). Moreover, note that, while Dean Henry Manne credits psychological and social factors that are consistent with his theory, *see* MANNE, *supra* note 16, at 150 (stating that psychological factors will lead insiders to produce favorable information, not to produce intentionally unfavorable information), he discredits psychological and social factors that are inconsistent with his theory. *Compare* Manne, *Administrative Process*, *supra* note 184, at 506 (criticizing the Commission and commentators when either references fairness), *with* MANNE, *supra* note 16, at 15 (acknowledging that moral standards play an important role in the business community and in the effective functioning of markets).

189. *See* Merrill Lynch v. Dabit, 547 U.S. 71, 78 (2006) ("The magnitude of the federal interest in protecting the integrity . . . of the market for nationally traded securities cannot be overstated.").

the onus is not on the agency to support its regulation with empirical analysis.[190] The party challenging the regulation bears that burden.

Critics of the Commission commonly offer logical arguments lacking in empirical support.[191] For example, critics of the Commission note that investors seemed to exhibit confidence in the U.S. securities markets for decades prior to the Commission's concerted efforts to stamp out insider trading in the 1980s.[192] The presence of investor confidence, however, does not address the underlying issue: What is the appropriate baseline for enforcement? What if pre-1980s investors exhibited confidence in the U.S. markets due to an absence of viable alternatives? What if non-U.S. markets during those decades were riddled with fraud, relative to U.S. markets?[193] Though investors may have exhibited confidence in the U.S. markets prior to the Commission's rigorous enforcement against insider trading, rigorous enforcement may enhance investor confidence such that the benefits of enforcement exceed the costs of enforcement.

Allowing Mr. O'Hagan or Mr. Cuban to trade may enhance the efficiency of the markets, which is valuable—but how valuable?[194] On the other side of the ledger, allowing insiders to trade creates moral hazards for insiders,[195] which imposes costs. What is the magnitude of those costs?[196] Reliable measures of the benefits and costs may not be

190. *See* Chamber of Commerce v. SEC, 412 F.3d 133, 142 (D.C. Cir. 2005) ("[W]e are acutely aware that an agency need not—indeed cannot—base its every action upon empirical data; depending upon the nature of the problem, an agency may be 'entitled to conduct . . . a general analysis based on informed conjecture.' . . . The Commission's decision not to do an empirical study does not make that an unreasoned decision.").

191. *See* Manne, *supra* note 150, at 570 (shifting the burden to the government to quantify the benefits of its regulation).

192. *See* Choi & Pritchard, *supra* note 109, at 35; Manne, *supra* note 150, at 577 ("[T]he public has never shown any signs of losing confidence in the stock market because of the existence of insider trading."); *see also id.* at 564 (noting the "scarcity" of SEC enforcement actions for insider trading during the 1960s); Langevoort, *supra* note 33, at 1620 (discussing the Commission's high-profile enforcement campaign against insider trading during the 1980s).

193. *See* Laura Nyantung Beny, *Do Insider Trading Laws Matter? Some Preliminary Comparative Evidence*, 7 AM. L. & ECON. REV. 144, 144 (2005) ("[C]ountries with more prohibitive insider trading laws have . . . *more accurate* stock prices, and *more liquid* stock markets. These findings are generally robust to controlling for measures of disclosure and enforceability and suggest that formal insider trading laws (especially their deterrence components) matter to stock market development.").

194. *See* Manne, *supra* note 150, at 566 ("The gains from efficiency are . . . often specifically unidentifiable.").

195. *See* 15 U.S.C. § 78p(c) (2006) (prohibiting directors, officers, and large shareholders from shorting equity securities of specified issuers); EASTERBROOK & FISCHEL, *supra* note 99, at 260; Eugene F. Fama & Kenneth R. French, *Q&A: Is Insider Trading Beneficial?*, FAMA/FRENCH FORUM (April 28, 2010), http://www.dimensional.com/famafrench/2010/04/qa-is-insider-trading-beneficial.html.

196. *See* Merrill Lynch v. Dabit, 547 U.S. 71, 78 (2006) ("The magnitude of the federal interest in protecting the integrity . . . of the market for nationally traded securities cannot be

easily obtained.[197] Even if obtained, "empirical evidence . . . can quickly go stale."[198]

Many economists disagree with the Commission's regulation of insider trading,[199] but other widely respected economists believe that insider trading should be prohibited.[200] Given disagreement among economists, why must the Commission accept the position of some economists (allow insider trading) rather than other economists (prohibit insider trading), particularly when Congress and the public favor the latter group?[201] The values emphasized by certain economists may not be the values emphasized by members of Congress, the Commission, or the public.

Congress entrusted the Commission to exercise its discretion in balancing competing evidence and viewpoints.[202] Sometimes scientific precision drives an agency's regulation, but sometimes an agency simply makes policy.[203] In § 10(b), Congress authorized the Commission—not the courts—to make policy. That an agency makes policy based upon political considerations should not strip the agency's discretion of deference by the courts.[204] Congress delegated the policy

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overstated.").

197. *See* MANNE, *supra* note 16, at 59, 70–71 (noting the lack of reliable data); Beny, *supra* note 193, at 145 (expressing a preference for empiricism but noting that the insider-trading debate has largely been theoretical); Langevoort, *supra* note 33, at 1623 ("[C]lean tests are often hard to come by.").

198. Langevoort, *supra* note 33, at 1606.

199. *See, e.g.*, Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 895 (1983); Meulbroek, *supra* note 174, at 1661–63. *See generally* Manne, *supra* note 150, at 547 (expressing gratification at the reception of his work by economists).

200. *See* Fama & French, *supra* note 195; *see also* Beny, *supra* note 193, at 144; Bhattacharya, *supra* note 174, at 76–78.

201. *See* Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 2, 98 Stat. 1264 (1984); H.R. REP. NO. 98-355, at 2 (1984), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2275 ("This legislation provides increased sanctions against insider trading in order to increase deterrence of violations."); Langevoort, *supra* note 33, at 1620 ("The routine of insider trading enforcement . . . cases . . . probably reflects the perception that these are the SEC's most reliable public relations tools.").

202. *See* Marsh v. Or. Natural Res. Council, 490 U.S. 360, 378 (1989) ("When specialists express conflicting views, an agency must have discretion to rely on the reasonable opinions of its own qualified experts even if, as an original matter, a court might find contrary views more persuasive.").

203. *See* BellSouth Corp. v. FCC, 162 F.3d 1215, 1221 (D.C. Cir. 1999) ("When . . . an agency is obliged to make policy judgments where no factual certainties exist or where facts alone do not provide the answer, our role is more limited; we require only that the agency so state and go on to identify the considerations it found persuasive."); Emily Hammond Meazell, *Super Deference, the Science Obsession, and Judicial Review as Translation of Agency Science*, 109 MICH. L. REV. 733, 751–52 (2011) (discussing the science charade).

204. *See* Kathryn A. Watts, *Proposing a Place for Politics in Arbitrary and Capricious Review*, 119 YALE L. J. 2, 66–68 (2009).

making function to the Commission, and courts should defer to the Commission's reasonable exercise of its discretion.[205] "[I]t is interesting how frequently economists find ex post that, notwithstanding the guesswork, the [Commission's] lawmaking predictions turn out reasonably well."[206]

The insightful criticisms of the ban on insider trading are not new,[207] but Congress has repeatedly enacted statutes that implicitly reject such criticisms.[208] The Commission has repeatedly rejected those criticisms through adjudication and rulemaking. When promulgating Rule 10b5-2(b)(1), the Commission indicated that the benefits of the rule included eliminating some of the uncertainty attendant to the regulation of insider trading,[209] and that it attributed no appreciable costs to the rule, and no commentator suggested otherwise.[210] Courts should defer to the Commission's considered judgment.

CONCLUSION

Commentators who have examined the validity of Rule 10b5-2(b)(1) have considered the Court's securities law jurisprudence, but in the process, they have paid little or no attention to the Court's developing administrative law jurisprudence. By not considering the role of administrative law, those commentators have approached the Commission's rule with undue skepticism. Deference to the Commission, however, is due.

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205. Manne, *Administrative Process*, *supra* note 184, at 510 ("[Insider trading] is not an area where we can condone the courts making policy because they are comparatively as well qualified as the agency.").

206. Langevoort, *supra* note 33, at 1626.

207. *See, e.g.*, MANNE, *supra* note 16; Manne, *supra* note 150, at 548 (noting warmer reception of his 1966 book by economists than by lawyers).

208. *See* Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 2, 98 Stat. 1264 (1984); H.R. REP. NO. 98-355, at 2 (1984), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2275 ("This legislation provides increased sanctions against insider trading in order to increase deterrence of violations.").

209. The Court has emphasized the need for certainty in the regulation of securities fraud. *See* Dirks v. SEC, 463 U.S. 646, 658 n.17 (1983) ("Unless the parties have some guidance as to where the line is between permissible and impermissible disclosures and uses, neither corporate insiders nor analysts can be sure when the line is crossed.").

210. *See* Selective Disclosure and Insider Trading, 65 Fed. Reg. 51716, 51729 (Aug. 24, 2000) (codified at 17 C.F.R. pt. 240 (2012)).