Fordham Urban Law Journal

Volume 40, *Number* 2 2013 *Article* 1

Helping Yourself While Serving Two Masters: Do Specialists Violate Rule 10b-5 When They Interposition?

Roman Asudulayev*

*Fordham University School of Law

Copyright ©2013 by the authors. *Fordham Urban Law Journal* is produced by The Berkeley Electronic Press (bepress). http://ir.lawnet.fordham.edu/ulj

Helping Yourself While Serving Two Masters: Do Specialists Violate Rule 10b-5 When They Interposition?

Roman Asudulayev

Abstract

The decision of the Second Circuit in United States v. Finnerty (Finnerty III) was the culmination of a number of District Court decisions that found that specialists on the New York Stock Exchange (NYSE) could not be held liable for fraud under Rule 10b-5 for interpositioning, whereby they put themselves between buy and sell limit orders, in violation of NYSE rules, and profited on the spread. Finnerty III and its District Court sibling decisions were wrongly decided. Specialists presented a uniquely thorny issue of agency law to the Federal Courts in New York. This issue was under-analyzed by the Federal Prosecutors and left the courts without a coherent theory of fiduciary duty for specialists. This Note will demonstrate that there is a fiduciary relationship between specialists and their public customers and will untangle that relationship to show that it prohibits interpositioning and that interpositioning was fraud under Rule 10b-5.

KEYWORDS: SEC; 10b-5; Fraud; Securities

HELPING YOURSELF WHILE SERVING TWO MASTERS: DO SPECIALISTS VIOLATE RULE 10B-5 WHEN THEY INTERPOSITION?

*Roman Asudulayev**

ABSTRACT

The decision of the Second Circuit in *United States v. Finnerty* (*Finnerty III*) was the culmination of a number of District Court decisions that found that specialists on the New York Stock Exchange (NYSE) could not be held liable for fraud under Rule 10b-5 for interpositioning, whereby they put themselves between buy and sell limit orders, in violation of NYSE rules, and profited on the spread. *Finnerty III* and its District Court sibling decisions were wrongly decided. Specialists presented a uniquely thorny issue of agency law to the Federal Courts in New York. This issue was under-analyzed by the Federal Prosecutors and left the courts without a coherent theory of fiduciary duty for specialists. This Note will demonstrate that there is a fiduciary relationship between specialists and their public customers and will untangle that relationship to show that it prohibits interpositioning and that interpositioning was fraud under Rule 10b-5.

* J.D. Candidate 2013, Fordham University School of Law. I would like to take this opportunity to thank Professor Sean J. Griffith for all of his excellent advice on this topic. I would also like to thank Nitzan Sternberg, Lauren Lombardo, Joanna Zdanys, and Joseph Kim, who have so graciously guided me through the long process of Note-editing. Without these people, this Note could not have been written.

INTRODUCTION

With increasing public furor over the actions of various financial institutions,[1] it is easy to forget that apparent fraud in finance can create tricky legal issues. In 2005, federal prosecutors charged fifteen broker-dealers on the New York Stock Exchange, called "specialists,"[2] with fraudulent trading.[3] The gist of the charge was that the specialists took advantage of trade requests that clients had sent to them.[4] Although specialists are allowed to trade on their own accounts, "when a buy order comes in at a higher price than a sell order, the specialist's duty is to match the customers rather than profit from the spread."[5] The practice of profiting from the spread is called "interpositioning."[6] Between 2005 and 2008, the Federal

1. *See, e.g.*, *Populism: Will There Be Blood?*, ECONOMIST, Mar. 26, 2009, *available at* 2009 WLNR 5800671.

2. For a full definition of a specialist see *infra*, Part I.A.

3. *See The New York Stock Exchange: Specialists Stumble*, ECONOMIST, Apr. 16, 2005, *available at* 2005 WLNR 5924073.

4. *Id.*

5. *Id.*

6. For a detailed discussion of interpositioning, see *infra* Part I.B and especially *infra* notes 43–44 and accompanying text.

Prosecutor for the Southern District of New York began fifteen prosecutions.[7] All fifteen failed ignominiously[8]: seven were dropped voluntarily; two ended in acquittal;[9] two guilty pleas were set aside; the government dropped a case against a fugitive;[10] two had their convictions overturned by the Second Circuit Court of Appeals;[11] and one individual, David Finnerty, had his conviction set aside by the District Court, and the Second Circuit upheld the decision.[12] Apparently, the government is quite unaccustomed to losing cases,[13] fifteen especially. How did this fiasco occur?

This Note will shed light on the operation of the NYSE, discuss the prosecutions, and explore the difficult legal questions they presented—questions that arguably have been left unanswered. Part I of this Note introduces the reader to the NYSE and its specialists, explains interpositioning, discusses the background law that relates to specialists—SEC Rule 10b-5,[14] fraud, and fiduciary duty—and explains some economic terminology that will later help put the role of specialists and interpositioning into perspective, and to consider this area of law from a more Legal Realist perspective.

Part II of this Note will discuss the logic used by the courts in their ultimate rejection of the allegation of fraud against specialists for interpositioning: the courts did not receive a strong argument that specialists were fiduciaries of their clients, meaning that mere theft by the specialists without any express promises to the contrary could not be considered fraud. Part II will also discuss the arguments that federal prosecutors put forth to show that the specialists were

7. *The New York Stock Exchange: Specialists Stumble*, *supra* note 3.

8. Dan Slater, *More Specialists Prosecutions Sour, Southern District of NY 0-15*, WALL ST. J. L. BLOG (Aug. 26, 2008, 9:34 AM), http://blogs.wsj.com/law/2008/08/26/more-specialist-prosecutions-sour-southern-district-of-ny-now-0-15/.

9. Chad Bray & Paul Davies, *Moving the Market: NYSE Ex-Floor Trader's Conviction Thrown Out in Latest Blow to U.S.—District Judge Says Government Failed to Prove Deception*, WALL ST. J., Feb. 22, 2007, at C1.

10. Chad Bray, *More Guilty Pleas Vacated in Probe of NYSE Trading*, WALL ST. J., Aug. 26, 2008, at C3.

11. United States v. Hayward, 284 F. App'x 857, 858 (2d Cir. 2008); Bray, *supra* note 10, at C3.

12. United States v. Finnerty (*Finnerty II*), 474 F. Supp. 2d 530, 547 (S.D.N.Y. 2007), *aff'd*, 533 F.3d 143 (2d Cir. 2008); Bray, *supra* note 10, at C3.

13. Paul Davies, *Specialists Mark Rare Setback for U.S. Attorney—Decision to Drop Remaining Cases Against Elite NYSE Floor Traders Follows Series of Miscalculations*, WALL ST. J., Nov. 24, 2006, at C1. A class action related to this subject matter is still ongoing. *See, e.g.*, *In re* NYSE Specialists Sec. Litig., 260 F.R.D. 55 (S.D.N.Y. 2009).

14. 17 C.F.R. § 240.10b-5 (2012).

fiduciaries of their clients and that therefore their actions amounted to fraud.

Part III of this Note explains that specialists play a negative role in the economy when they interpose themselves as traders between their customers, and therefore are an appropriate target for Rule 10b-5 fraud prosecution. Part III demonstrates how the arguments of the prosecution were correct in their conclusion but not in their reasoning, meaning that the courts were right to reject those arguments. Part III concludes that specialists were agents of their clients because they were their brokers, who are agents of their clients to the extent of executing their clients' trades. As agents, these brokers had a fiduciary duty not to trade for their own benefit without their clients' knowledge, as both a formal matter and by analogy to other legal doctrines.

I. THE LEGAL BACKGROUND OF INTERPOSITIONING AND SOME ECONOMICS

This Part discusses the background concepts and law behind the interpositioning prosecutions. It defines the term "specialist"[15] and the act of interpositioning.[16] This Part also explains the relation of fraud under Rule 10b-5 to breaches of fiduciary duty generally.[17] It then discusses two practices that are analogous to interpositioning: trading ahead[18] and insider trading.[19] This Part also offers a discussion of fiduciary duty, both in its inception[20] and its operation.[21] And, finally, it explains some economic terminology that shall be useful to understand the role that interpositioning plays in the financial system.[22]

15. *See infra* Part I.A.
16. *See infra* Part I.B.
17. *See infra* Part I.C.
18. *See infra* Part I.D.1.
19. *See infra* Part I.D.2.
20. *See infra* Part I.E.1.
21. *See infra* Part I.E.2.
22. *See infra* Part I.F. For my analysis of interpositioning as an economic phenomenon, see *infra* Part III.A.

A. Specialists

Specialists have a long history whose beginnings are obscured by legend.[23] "In simplest terms," George T. Simon and Kathryn M. Trkla describe the specialist as "a member of an exchange that *specializes* in trading a particular security or group of securities as broker or as dealer."[24] Thus, when a member of the public wants to buy a particular security at the NYSE, she must go through a specialist[25] unless she trades electronically. In other words, "[s]pecialists act as auctioneers in the specific stocks they are designated to trade."[26] Thus, part of the specialist's role is to match up bids and offers,[27] acting as a sort of "brokers' broker," taking orders from public customers' brokers to buy or sell securities.[28] Generally, there are two kinds of orders that specialists take: market orders, which are orders to buy or sell a security at the market price, and limit orders, which are orders to buy or sell only if a certain price is available.[29] Generally, a bid limit order will ask that a security be bought only when it is at or below a certain price, while an offer limit

23. J. Scott Colesanti, *Not Dead Yet: How New York's Finnerty Decision Salvaged the Stock Exchange Specialist*, 23 ST. JOHN'S J. LEGAL COMMENT. 1, 2–3 (2008). Note also that specialists are now called designated market makers, or DMMs. *See* NYSE, NEXT GENERATION MODEL 1 (2008)¸ *available at* http://www.nyse.com/pdfs/Next_Generation_Model.pdf. However, this article will refer to them as 'specialists' since that is the term used by the courts that dealt with the issue. *See, e.g.*, United States v. Finnerty (*Finnerty III*), 533 F.3d 143, 145 (2d Cir. 2008) ("Appellee David Finnerty was a specialist at the New York Stock Exchange . . . .").

24. George T. Simon & Kathryn M. Trkla, *The Regulation of Specialists and Implications for the Future*, 61 BUS. LAW. 217, 222 (2005).

25. *See* NEW YORK STOCK EXCHANGE, A GUIDE TO THE NYSE MARKET PLACE 7 (2d ed. 2006), *available at* http://www.nyse.com/pdfs/nyse_bluebook.pdf (illustrating how a member of the public sells a security and the role that the specialist plays in the sale). Other stock exchanges have specialists, too. *See* Simon & Trkla, *supra* note 24, at 222 ("The precise functions performed by specialists . . . vary based upon the characteristics of the exchange market in which they operate."). But because the prosecutions of specialists all dealt with NYSE specialists, the NYSE is the focus of this Note.

26. NEW YORK STOCK EXCHANGE, *supra* note 25, at 6.

27. *In re* NYSE Specialists Sec. Litig., 503 F.3d 89, 92 (2d Cir. 2007). For the remainder of this Note, the terms 'bid' and 'offer' will have specific meanings. A 'bid' will describe an offer to buy a security at a certain price; an 'offer' (except as used within this definition) will describe an offer to sell a security at a certain price. Thus a bid price is the price at which the bidder is willing to buy a security; the offer price is the price at which the offeror is willing to sell that security.

28. Simon & Trkla, *supra* note 24, at 223.

29. 5 THOMAS LEE HAZEN, LAW OF SECURITIES REGULATION §14.13[1], at 364 (6th ed. 2009).

order will ask that a security be sold only when it is at or above a certain price.[30]

Yet, specialists also have a second function: they can buy and sell securities on their own accounts.[31] Specifically, specialists may buy or sell securities when there are no matching orders.[32] In other words, when there is a bid limit order that is too low for any existing offers, the specialist *may* take the opposite side of the bid, and sell at the bid price to prevent erratic market shifts.[33] Another way to describe this function is to say that specialists provide liquidity to the market, by providing buyers or sellers for securities, when there would otherwise be an imbalance.[34] In this capacity, specialists act as "market makers."[35] New York Stock Exchange Rule 104 prohibits specialists from trading on their own account as market makers unless there are no matchable customer orders.[36] As a corollary, specialists are supposed to match orders at either the bid or offer price.[37]

30. *Id.*

31. *In re* NYSE Specialists Sec. Litig., 405 F. Supp. 2d 281, 290 (S.D.N.Y. 2005), *rev'd on other grounds*, 503 F.3d 89 (2d Cir. 2007).

32. 5 HAZEN, *supra* note 29, at 342.

33. *Id.* at 342–43.

34. *See In re* NYSE Specialists Sec. Litig., 503 F.3d 89, 92 (2d Cir. 2007).

35. Specialists are not proper market makers because their primary function is not to trade on their own account, but rather to broker trades between other traders. *Cf.* 5 HAZEN, *supra* note 29, at 310 (describing the role of market makers on "over the counter" exchanges); *infra* note 126. Yet, specialists make a market insofar as they still act as counter-parties to traders who cannot find a market for a security that those traders would like to buy or sell. *See* 5 HAZEN, *supra* note 29, at 344 (noting that one of the duties of a specialist is to "manage supply and demand imbalances").

36. *Finnerty II*, 474 F. Supp. 2d 530, 533 (S.D.N.Y. 2007), *aff'd*, 533 F.3d 143 (2d Cir. 2008); 5 HAZEN, *supra* note 29, at 344–45; NEW YORK STOCK EXCHANGE RULE 104T(a) (2013), *available at* http://nyserules.nyse.com/nysetools/PlatformViewer.asp?SelectedNode=chp_1_2&manual=/nyse/rules/nyse-rules/ ("No DMM [specialist] shall effect on the exchange purchases or sales of any security in which such DMM [specialist] is registered . . . unless such dealings are reasonably necessary to permit such DMM to maintain a fair and orderly market . . . ."); Bear Wagner Specialists, L.L.C., New York Stock Exchange Hearing Panel Decision 04-51, ¶¶ 29–30 (Mar. 29, 2004), *available at* http://www.nyse.com/pdfs/04-051.pdf; *see also* NEW YORK STOCK EXCHANGE RULE 476(a)(6) (2010), *available at* http://nyserules.nyse.com/nysetools/PlatformViewer.asp?SelectedNode=chp_1_7&manual=/nyse/rules/nyse-rules/ (making "failing to observe high standards of commercial honor and just and equitable principles of trade" a violation of the rules). Note that the current Rule 104T(a) was, at the time of the alleged violations, called Rule 104. *See Bear Wagner*, New York Stock Exchange Hearing Panel Decision 04-51, ¶ 30; NEW YORK STOCK EXCHANGE RULE 104 (2003) ("No specialist shall effect on the Exchange purchases or sales of any security in which such specialist is registered . . . unless such dealings are reasonably necessary to permit such specialist to maintain a fair and orderly market . . . ."). Exchanges, such as the NYSE, are to be regulated by the Securities

Finally, specialists receive commissions for trades that they help broker.[38] Interestingly, this fact was subject to some controversy: some of the courts specifically stated that specialists *were not* compensated by their clients through commission.[39] This may be because the government appears to have conceded that specialists are not compensated for these kinds of trades.[40] Specialists *are no longer* compensated through commissions for the trades that they broker; rather, they are compensated through a profit-sharing system, whereby the NYSE will pay them directly.[41] What one must keep in mind is that at the time of specialist prosecutions, specialists *were*

---

and Exchange Commission (SEC), under Section 11(b) of the Securities and Exchange Act of 1934. 15 U.S.C. § 78K-1(b) (2012). The SEC produced Rule 11b-1, which forced exchanges to make their own rules regarding specialists. 17 C.F.R. § 240.11b-1 (2012); *see also* Colesanti, *supra* note 23, at 13.

37. *See, e.g.*, Fleet Specialist, Inc., Exchange Act Release No. 34-49499, 82 SEC Docket 1895, at *3 (Mar. 30, 2004) (discussing what a specialist should do when there are two matchable orders with different prices).

38. 5 HAZEN, *supra* note 29, at 342 (explaining that when "[t]he specialist acts solely as subagent, [she] receiv[es] a portion of the 'book' customer's commission to his broker"). At the time of Finnerty's actions, 1999–2003, *see Finnerty II*, 474 F. Supp. 2d at 532, the NYSE specialists received a commission, *see Member-Firm Fee Cap and Specialist Commissions on NYSE-Listed Equity Trading to Be Eliminated*, NYSE EURONEXT (Dec. 2006), http://www.nyse.com/about/publication/1165230695660.html (stating that in and before December 2006, specialists were compensated by commission).

39. *Compare* 5 HAZEN, *supra* note 29, at 342 (discussing how specialists receive a part of the public customer's broker's fee), *and* Colesanti, *supra* note 23, at 3 (noting that specialists "shar[e] in the commission"), *with Finnerty II*, 474 F. Supp. 2d at 544 n.10 (citing United States v. Hunt, No. 05 CR. 395(DAB), 2006 WL 2613754, at *6 (S.D.N.Y. Sept. 6, 2006)) (agreeing that specialists are not compensated by their public customers).

40. *See, e.g.*, Indictment ¶ 4, United States v. Hunt, No. 05 CR. 395(DAB) (S.D.N.Y. Sept. 6, 2006), 2005 WL 5973581. The confusion may stem from the fact that individuals may not be compensated by brokerage commissions, but by a salary and bonus, *see Finnerty II*, 474 F. Supp. 2d at 535 (discussing Finnerty's compensation), while the firms themselves are compensated with commissions, *see supra* note 38.

41. Notice of Proposed Rule Change to Institute a Revised System of Payments to Specialist Firms, 72 Fed. Reg. 51,287 (Sep. 6, 2007) (effecting new plan for specialist compensation by profit sharing with the NYSE); Notice of Proposed Rule Change to Prohibit Specialists from Charging Transaction Fees in their Specialists Securities, 71 Fed. Reg. 71,217 (Dec. 8, 2006); NEW YORK STOCK EXCHANGE RULE 104B (2008), *available at* http://nyserules.nyse.com/NYSETools/PlatformViewer.asp?searched=1&selectednode=chp_1_3_7_12&CiRestriction=104B&manual=%2Fnyse%2Frules%2Fnyse-rules%2F; NYSE EURONEXT, *supra* note 38. The NYSE changed this payment procedure in order to create a better incentivize specialists to create liquidity in their respective markets for shares. *See* Notice of Proposed Rule Change to Institute a Revised System of Payments to Specialist Firms, 72 Fed. Reg. at 51,287–88.

compensated for the orders that they brokered between their public customers.[42]

B. Interpositioning

Interpositioning is occasioned by a pair of matchable limit orders for some security, say a bid limit order at $100 and an offer limit order at $99.90.[43] The specialist "interposes" when she buys the security from the offeror, at $100, and then sells to the bidder at $99.90, pocketing ten cents on the trade.[44] In this way, specialists can take advantage of their function of receiving limit orders[45] and their ability to buy and sell on their own accounts[46] by *interposing* themselves between a lower offer price and higher bid offer and trading on their own accounts, to buy from the offeror and then resell to the bidder.[47] These trades added up to a rather large amount: $158 million of lost client money, with one firm taking $38 million.[48]

Thus, in 2005, the U.S. Attorney for the Southern District of New York indicted fifteen individuals working for specialist firms for fraud under Section 10(b) of the Securities Exchange Act of 1934[49] and Rule 10b-5[50] for interpositioning.[51] These indictments followed on the

42. *See supra* note 39 and accompanying text.

43. By definition, any order where the bid is higher than the offer is matchable because whenever a buyer is willing to pay more than the seller wants, some bargain is possible between the two parties. *See also supra* notes 25–26 and accompanying text (explaining how specialists are made aware of bids and offers when they act as brokers for brokers). On the other hand, if the bid is for a lower price than the offer, there cannot be a trade. *See* 5 HAZEN, *supra* note 29, at 342–43 (showing how a bid that is lower than the offer leads to inaction in the market, and may cause volatility without the intervention of specialists). Orders that specify a price limit (bid or offer) are limit orders. *See supra* notes 29–30 and accompanying text.

44. Emil J. Bove III, *Institutional Factors Bearing on Criminal Charging Decisions in Complex Regulatory Environments*, 45 AM. CRIM. L. REV. 1347, 1361 (2008) (giving an analogous example).

45. *See supra* notes 26–29 and accompanying text.

46. *See supra* notes 31–33 and accompanying text.

47. *See supra* notes 43–44 and accompanying text.

48. *See, e.g.*, Fleet Specialist, Inc., Exchange Act Release No. 34-49499, 82 SEC Docket 1895, at *1 (Mar. 30, 2004) (noting that one specialist firm made $38 million through interpositioning between 1999 and 2003); Aaron Lucchetti & Kara Scannel, *Fifteen Indicted in NYSE Case—Elite Specialists Are Charged; Exchange Also Settles Civil Charge and Will Videotape Its Traders*, WALL ST. J., Apr. 13, 2005, at C1 (specialists cost their clients $158 million).

49. 15 U.S.C. § 78j(b) (2006).

50. 17 C.F.R. § 240.10b-5 (2012). Rule 10b-5 specifies the conduct that violates Section 10(b). *Id.* An intentional violation of Section 10(b), along with violations of

heels of a settlement between the Securities and Exchange Commission (SEC) and the specialist firms, as well as another settlement with the NYSE.[52]

The courts generally found that interpositioning did not violate Rule 10b-5 because the government could not prove deception[53] or any untrue or misleading statements[54]—or statements made misleading by an omission.[55] The Second Circuit, reviewing the District Court's decision in *Finnerty II*, which set aside a guilty verdict by the jury, stated that although specialists' interpositioning may have been conversion, it could not rise to the level of fraud, unless there were an accompanying breach of fiduciary duty.[56] The courts generally found no fiduciary duty on the parts of the specialists.[57] There were two explanations. First, the courts concluded that the specialists were not paid by their customers, and therefore specialists could not be the agents of their customers.[58] Second, if specialists *were* to be the agents of their customers, specialists would then have two fiduciary relationships to two adversely positioned parties: a buyer and a seller.[59]

most other section of the Securities Exchange Act of 1934, carries with it criminal sanctions, under Section 32(a) of the Act. 15 U.S.C. § 78ff(a) (2006).

51. *See* United States v. Finnerty (*Finnerty I*), Nos. 05 Cr. 393 DC, 05Cr. 391 DC, 2006 WL 2802042, at *1 (S.D.N.Y. Oct. 2, 2006); United States v. Hunt, No. 05 CR. 395(DAB), 2006 WL 2613754, at *1 (S.D.N.Y. Sept. 6, 2006); United States v. Bongiorno, No. 05 CR. 390(HHS), 2006 WL 1140864, at *1 (S.D.N.Y. May 1, 2006); Lucchetti & Scannell, *supra* note 48, at C1.

52. Lucchetti & Scannell, *supra* note 48, at C1.

53. *See, e.g.*, *Finnerty II*, 474 F. Supp. 2d 530, 539–40 (S.D.N.Y. 2007), *aff'd*, 533 F.3d 143 (2d Cir. 2008) (discussing how violations of Subsections (a) and (c) of Rule 10b-5 need a showing of customer expectations). The court was initially open to the possibility that the government *could* show that specialists deceived investors. *See, e.g.*, *Finnerty I*, 2006 WL 2802042, at *4–5. The court eventually decided that this required a showing of specific representations by the defendant or some showing of general customer expectations, which the government failed to produce. *Finnerty II*, 474 F. Supp. 2d at 539–40.

54. *See, e.g.*, *Hunt*, 2006 WL 2613754, at *4.

55. *See, e.g.*, *Bongiorno*, 2006 WL 1140864, at *7.

56. *See Finnerty III*, 533 F.3d 143, 148–49 (2d Cir. 2008) (citing *In re* Refco Capital Mkts., Ltd., Brokerage Customer Sec. Litig., No. 06 Civ. 643(GEL), 2007 WL 2694469, at *8 (S.D.N.Y. Sept. 13, 2007)).

57. *See, e.g.*, *Hunt*, 2006 WL 2613754, at *6.

58. *See, e.g.*, *Finnerty II*, 474 F. Supp. 2d at 544 n.10 (citing *Hunt*, 2006 WL 2613754, at *6). For a discussion of the veracity of this claim see *supra* notes 39–40 and accompanying text.

59. *See, e.g.*, *Finnerty II*, 474 F. Supp. 2d at 544 (citing *Hunt*, 2006 WL 2613754, at *6). The specifics of the courts' decisions will be discussed *infra* Part II.A.

Yet, before the interpositioning cases went to trial, the SEC found interpositioning to be a violation of Rule 10b-5.[60] Moreover, it settled with all the specialist firms that it accused of interpositioning.[61] The SEC also settled with the NYSE for the interpositioning claims[62] because interpositioning is a violation of NYSE Rules[63] and the NYSE failed to monitor its specialists and prevent their

60. *See, e.g.*, Fleet Specialist, Inc., Exchange Act Release No. 34-49499, 82 SEC Docket 1895, at *6 (Mar. 30, 2004). One might ask why it is that if the SEC found deception in the actions of the specialists, it was not accorded *Chevron* deference in interpreting its organizational statute, *see* Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 843–45 (1984), which is the Securities Exchange Act of 1934 for the SEC, *see* Securities and Exchange Act of 1934 § 4, 15 U.S.C. § 78(d) (2006). But, administrative agencies, such as the SEC, do not get *Chevron* deference for interpretations of statutes that courts do not consider ambiguous. Nat'l Credit Union Admin. v. First Nat'l Bank & Trust Co., 522 U.S. 479, 500 (1988). Thus, the Supreme Court has always started its analysis of Rule 10b-5 deception and fraud by referring to the text of Section 10(b) of the Securities Exchange Act of 1934 and interpreting the term 'deception' on its own. *See, e.g.*, Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472–73 (1977) ("The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is 'the power to adopt regulations to carry into effect the will of Congress as expressed by the statute.' . . . [The scope of the Rule] cannot exceed the power granted the Commission by Congress under s 10(b)." (alteration and omission in original) (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 213–14 (1976)) (internal quotation marks omitted)); *see also* United States v. O'Hagan, 521 U.S. 642, 679 (1997) (Scalia, J., concurring in part and dissenting in part) (noting that no *Chevron* deference was given to the SEC's interpretation of Section 10(b) or Rule 10b-5). The SEC's power extends only towards filling in "gaps" in its statutes, *see* Roth *ex rel.* Beacon Power Corp. v. Perseus, L.L.C., 522 F.3d 242, 248–49 (2d Cir. 2008), but there are no gaps in the term 'deceptive device' in Section 10(b) or any delegation for the SEC to define that or any other term in Section 10(b), *see* 15 U.S.C. § 78j(b) (2006). Similarly, the SEC would be hard-pressed to argue that it had *Auer* deference, given to agencies' interpretations of *their own regulations* in any way *not* "plainly erroneous or inconsistent with regulation," Auer v. Robbins, 519 U.S. 452, 461 (1997) (internal quotation marks omitted) (citing Robertson v. Methow Valley Citizens Council, 490 U.S. 332, 359 (1989)), because *Auer* deference is only applicable when the underlying regulation is well within the limits of *Chevron* deference, *cf. id.* at 456 ("The [statute] grants the Secretary broad authority to 'defin[e] and delimi[t]' the scope of the exemption for executive, administrative, and professional employees." (alterations in original) (quoting 29 U.S.C. § 213(a)(1) (2006))). Thus, courts interpreting Rule 10b-5 are free to ignore the SEC's own views as to what constitutes deception and simply interpret 'deception' in Section 10(b). *Santa Fe*, 430 U.S. at 472 (citing *Ernst & Ernst*, 425 U.S. at 197). For the SEC's view on interpositioning as fraud, see *infra* notes 222–225 and accompanying text.

61. Lucchetti & Scannell, *supra* note 48, at C1.

62. *Id.*

63. *See* Bear Wagner, Inc., New York Stock Exchange Hearing Panel Decision 04-51, ¶¶ 29–30 (Mar. 29, 2004), *available at* http://www.nyse.com/pdfs/04-051.pdf (ruling that interpositioning is a violation of NYSE Rule 104).

interpositioning.[64] The NYSE itself also penalized specialist firms for interpositioning.[65]

Finally, in a decision certifying a class action against the NYSE specialists, *In re NYSE Specialists Securities Litigation*, the court appears to have been open to the idea that the class would be able to prove some manner of deception.[66] If the class were able to prove that it was deceived by the specialists, it would be able to make out a case of fraud without proving fiduciary duty because, in short, fiduciary duty is merely one route to showing fraud: if one has garden variety deception, one need not show fiduciary duty.[67]

C. Rule 10b-5 and Fraud

Rule 10b-5, which specifies the acts that make up a violation of Section 10(b) of the Securities and Exchange Act of 1934,[68] makes it illegal to use the national stock exchanges for any of the following three purposes, "in connection with the purchase or sale of any security": (a) commit fraud, (b) make untrue statements or omit to make statements that would make other statements, already made, misleading, or (c) engage in an "act, practice, or course of business which operates as a fraud."[69] Fraud, itself, is misrepresentation or deception; its elements are material misrepresentation, scienter,

---

64. Lucchetti & Scannell, *supra* note 48, at C1.

65. *See Bear Wagner*, New York Stock Exchange Hearing Panel Decision 04-51, ¶¶ 29–30.

66. 260 F.R.D. 55, 75 (S.D.N.Y. 2009) (noting that the class may be able to prove that specialist firms engaged in deceptive practices, within the context of showing predominance, pursuant to a class action). This action has been settled with respect to the NYSE, a party to the litigation. Stipulation of Partial Settlement at 1, *In re* NYSE Specialists Sec. Litig., No. 1:03-cv-08624-RWS (Apr. 4, 2010), *available at* http://securities.stanford.edu/1029/NYSE03-01/2010414_r01s_03CV08264.pdf. However, the class action against the specialist firms is still ongoing; as of March 28, 2011 the settlement agreement had not been finalized. *See* Memorandum from David Rosenfeld on NYSE Specialists Distribution Funds (Mar. 28, 2011), *available at* http://www.sec.gov/litigation/admin/311445/311445-18.pdf.

67. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977) (explaining that fraud under Rule 10b-5 is only relevant as a showing of deception under Section 10(b)). For a discussion of fraud, see *infra* Part I.C. For a discussion of fiduciary duty, see *infra* Part I.E. For the courts' discussions of whether specialists might owe a fiduciary duty, see *infra* Part II.A, and for my view of the matter see *infra* Parts III.B, III.C, and III.D.

68. *See* 15 U.S.C. § 78j(b) (2006).

69. 17 C.F.R. § 210.10b-5 (2012).

reliance, and causation.[70] A fraud is when one party intentionally deceives (scienter and material misrepresentation) another party into making some action (reliance) that is damaging to the deceived party (causation).[71] Thus, a violation of Rule 10b-5 and Section 10(b) requires the following elements: scienter, misrepresentation of a material fact, reliance causation, and the purchase of a security,[72] which are the requirements of fraud, along with the requirement that there be a purchase or sale of a security.[73]

Breaching a fiduciary duty *can* but does not always lead to a finding of fraud.[74] It is important to understand that not all breaches of fiduciary duty are fraud.[75] Some fiduciary duties are based on the duty of care; the breach of such duty is regrettable but not necessarily *deceptive*.[76] But a breach of the fiduciary duty to disclose information can be *deceptive* and thereby fraud.[77] This is because when there is an affirmative duty to disclose information, a lack of disclosure suggests that there is no information to disclose. Thus, when something happens that a fiduciary was under duty to disclose, the absence of disclosure is akin to stating that nothing has happened: this is *deception*; and so it is also *fraud*.[78] Statements are not necessary for fraud: "conduct itself can be deceptive."[79]

---

70. RESTATEMENT (SECOND) OF TORTS §§ 525–26, 529 (1977). Scienter is knowledge that what one is representing as true is false, or uncertainty that what one is representing as true is true. *See id.* § 526.

71. *See id.*

72. *See* Burke v. Jacoby, 981 F.2d 1372, 1378 (2d Cir. 1992).

73. The elements of fraud are coextensive with those of a Rule 10b-5 violation but for the latter's requirement that the misrepresentation be with regard to the sale or purchase of a security. *Compare id.*, *with* RESTATEMENT (SECOND) OF TORTS §§ 525–26, 529 (1977) (stating and explaining the elements of fraud).

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

75. *See id.*

76. *See id.* at 470, 474 (rejecting the lower court's determination that an action that was made without a justifiable business purpose could be fraud even though there was no deception or manipulation).

77. *See* Chiarella v. United States, 445 U.S. 222, 230 (1980) ("[S]ilence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b) . . . . [But such liability is premised upon] a duty to disclose arising from a relationship of trust and confidence between parties to a transaction.").

78. *See id.*; United States v. Dial, 757 F.2d 163, 168 (7th Cir. 1985) ("Fraud in the common law sense of deceit is committed by deliberately misleading another by words, by acts, or, in some instances—notably where there is a fiduciary relationship, which creates a duty to disclose all material facts—by silence." (citing W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS §§ 105–06 (5th ed. 1984))). One of the reasons that it seems hard to find a simple expression of the way that fiduciary duty may lead to fraud is because, originally, fraud was an action in

D. Some Possible Analogies to Interpositioning

Before moving on to when fiduciary duties are created[80] and what fiduciary duties entail,[81] it is useful to set the stage by considering two practices similar to interpositioning that are outlawed: trading ahead[82] and insider trading.[83]

1. Trading Ahead

Interpositioning appears to be very similar to a prohibited practice called trading ahead. Trading ahead occurs when a broker buys a security, while knowing that one of her customers will buy that security later.[84] Brokers are well positioned to do this because brokers receive orders from their customers and thus know what their customers will buy.[85] In *United States v. Dial*, the Seventh Circuit ruled that trading ahead is a fraud under the mail and wire fraud statutes[86] because it is a failure "to 'level' with one to whom one owes fiduciary duties."[87] In that case, broker Donald Dial, the defendant, solicited a large order for silver futures from his customers, but before he put that order on the market he put in an order for himself (and his brokerage house).[88] Once Dial decided that the price was too high, he sold his (and his brokerage house's) silver future positions first, before selling those of his customers, whom he had solicited to sell the futures, as well.[89] Thus, he first denied his customers a lower

law, *see, e.g.*, Moseley v. All Things Possible, Inc., 694 S.E.2d 43, 45 (S.C. Ct. App. 2010), while breach of fiduciary duty was an action in equity, *see, e.g.*, *In re* Evangelist, 760 F.2d 27, 29 (1st Cir. 1985).

79. *See* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 158 (2008); *see also Dial*, 757 F.2d at 168 ("But if someone asks you to break a $10 bill, and you give him two $1 bills instead of two $5's because you know he cannot read and won't know the difference, that is fraud.").

80. That is, when a fiduciary relationship is created. *See* RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006). This issue is discussed *infra* Part I.E.1.

81. The nature of fiduciary duties and the difference between the duty of ordinary care and the duty of disclosure are discussed *infra* Part I.E.2.

82. Trading ahead is illegal under *Dial*, 757 F.3d, and it is discussed in the following Section: I.D.1.

83. Insider trading has been illegal ever since SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968). Insider trading is discussed *infra* Part I.D.2.

84. *See Dial*, 757 F.2d at 165–66.

85. *See id.*

86. *See* 18 U.S.C. §§ 1341, 1343 (2006); *Dial*, 757 F.2d at 168–69.

87. *See Dial*, 757 F.2d at 168.

88. *See id.* at 166–67.

89. *See id.*

buying price and then a higher selling price, taking both for himself.[90] The Seventh Circuit, in a lucid opinion by Judge Richard Posner, explained that brokers owe a fiduciary duty to their customers to get them the best possible price.[91]

Dial misled his customers when he solicited their orders but did not get them the best possible price.[92] He traded ahead of his customers, putting his large personal order ahead of their orders.[93] His large order pushed up the price of silver for the customers, whose orders were filled at the increased market price.[94] The corollary of this was that Dial's earlier order benefitted from the price increase that was brought about by the subsequent large customer order.[95] Similarly, when it was time to sell, Dial sold off his large order first, at a higher price, and then executed his customer's sell orders afterwards, at a price that was deflated by Dial's own large sell order.[96] In this way, Dial was able to buy at a relatively lower price and sell at a relatively higher price, to his benefit and to his customers' detriment.[97] He thus made a profit by misleading his customers, which was fraud.[98]

Although trading ahead has been likened to interpositioning,[99] *Dial* differs from the interpositioning prosecutions in that Dial solicited orders,[100] while interpositioning does not require any solicitation, since limit orders come to specialists as a matter of course.[101] Moreover, the *Dial* court found that brokers are fiduciaries of their clients,[102] while the interpositioning cases did not find that specialists

90. *See id.*

91. *See id.* at 168 (citing Marchese v. Shearson Hayden Stone, Inc., 734 F.2d 414, 418 (9th Cir. 1984)).

92. *See id.*

93. *See id.*

94. *See id.*

95. *See id.*

96. *See id.*

97. *See id.*

98. *See id.* (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 183, 194–95 (1963)).

99. *See, e.g.*, Fleet Specialist, Inc., Exchange Act Release No. 34-49499, 82 SEC Docket 1895, at *4 (Mar. 30, 2004) (explaining that trading ahead is like interpositioning, except that there is not necessarily a second trade); Colesanti, *supra* note 23, at 22 (noting that interpositioning is related to trading ahead).

100. *See supra* note 88 and accompanying text.

101. Specialists receive customer orders passively. *See supra* notes 25–28 and accompanying text.

102. *See Dial*, 757 F.2d at 168.

are fiduciaries of their customers,[103] nor did those courts even agree that *brokers* are fiduciaries of their customers.[104]

2. Insider Trading

Another analogy to interpositioning is insider trading. Trading ahead, somewhat similar to interpositioning,[105] has been equated to insider trading.[106] Insider trading is trading on material non-public information in breach of a fiduciary duty.[107] The "classical theory" of insider trading—so termed in *United States v. O'Hagan*[108]—was premised on the fiduciary duty of loyalty that an employee of a corporation owed to the shareholders of a corporation not to buy stocks from those shareholders using information that the employee should have disclosed to the shareholders.[109]

Another theory is the misappropriation theory, coined by the government, in *O'Hagan*.[110] Insider trading can also be fraud when it breaches a fiduciary duty of loyalty to the source of information.[111] In *O'Hagan*, the source of information was a company, Grand Metropolitan PLC (Grand Met) that intended to buy another firm, Pillsbury Co.[112] Grand Met had hired defendant James O'Hagan's law firm in connection with the purchase.[113] O'Hagan then went on to buy shares of Pillsbury, the acquisition target, and resold them when they rose as a result of the public takeover announcement.[114] In other

103. *See, e.g.*, *Finnerty II*, 474 F. Supp. 2d 530, 544 & n.10 (S.D.N.Y. 2007), *aff'd*, 533 F.3d 143 (2d Cir. 2008). For a discussion of specialist fiduciary duty, see *infra* Parts I.E, III.B, III.C, and III.D.

104. *See, e.g.*, United States v. Hunt, No. 05 CR. 395(DAB), 2006 WL 2613754, at *5 (S.D.N.Y. Sept. 6, 2006) (citing De Kwiatkowski v. Bear, Stearns & Co., 306 F.3d 1293, 1308–09 (2d Cir. 2002); Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 536 (2d Cir. 1999); Bissel v. Merrill Lynch & Co., 937 F. Supp. 237, 246 (S.D.N.Y. 1996)).

105. *See supra* note 99.

106. *See Dial*, 757 F.2d at 167–68 (equating trading ahead to insider trading).

107. *See, e.g.*, United States v. O'Hagan, 521 U.S. 642, 651–52 (1997) (citations omitted) (discussing the "classical" and "misappropriation" theories of insider trading).

108. *See id.* at 651.

109. *See* Chiarella v. United States, 445 U.S. 222, 227–29 (1980); Cady, Roberts & Co., Exchange Act Release No. 34-6668, 40 S.E.C. 907, at *3 (Nov. 8, 1961) (stating that an insider of a corporation must either disclose her information to the shareholders or forego trading on the security).

110. *See* 521 U.S. at 652.

111. *See id.*

112. *See id.* at 647.

113. *See id.*

114. *See id.* at 648.

words, the holding of *O'Hagan* was that a fiduciary of a buyer corporation[115] owed a duty, to the buyer, not to buy the shares of a company whose shares the principal (the buyer) wanted to buy. O'Hagan had "misappropriated" information: the knowledge of the buyer's intention to buy shares of a company, before that intention was made public.[116] At this point, it is useful to note the similarity of the misappropriation theory of insider trading to trading ahead: in both scenarios, a fiduciary knows that a principal will be making a purchase and then buys *ahead* of the principal, knowing that the value of the thing purchased shall increase as a result of the principal's purchase.[117] In both situations the principal is robbed of the ability to make use of its information for its sole benefit.[118]

E. The Fiduciary Duties of Specialists

There are two components to understanding the fiduciary duties of specialists. First, when does fiduciary duty attach to the actions of specialists?[119] And second, if some fiduciary duty does exist, what are the contours of that fiduciary duty?[120]

1. Establishing Fiduciary Duty

One commentator, in arguing that specialists stood to gain from old-fashioned insider trading, said, without explaining, that specialists owed a fiduciary duty to their customers when trading on their behalf.[121] And, early courts were quite ready to identify specialists as

115. Lawyers are fiduciaries of companies during buy-out deals. Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983).

116. *See O'Hagan*, 521 U.S. at 652–53.

117. *Compare* United States v. Dial, 757 F.2d 163, 165–68 (7th Cir. 1985) (describing the practice of trading ahead), *with O'Hagan*, 521 U.S. at 647–48 (describing the acts of O'Hagan in purchasing the stock of his principal's acquisition target before the acquisition did and making a tidy profit when the target was finally bought).

118. *Compare Dial*, 757 F.2d at 165–66, 168 (describing the damage to the customers of a broker when the broker traded ahead), *with O'Hagan*, 521 U.S. at 654 (citing Carpenter v. United States, 484 U.S. 19, 25–27 (1987)) (describing the damage to a principal when a fiduciary misappropriates the principal's information).

119. A discussion of whether and when fiduciary duties attach to the actions of specialists follows *infra* Part I.E.1.

120. For a discussion of the kinds of fiduciary duties there are between agents and principles, see *infra* Part I.E.2.

121. *See* Note, *The Downstairs Insider: The Specialist and Rule 10b-5*, 42 N.Y.U. L. REV. 695, 697 (1967) ("As broker, the specialist holds and executes orders for the

fiduciaries of their customers.[122] At the very least, early courts held that the specialist was a subagent of the customer's broker, who was, in turn, an agent of the public customer.[123] Subagency is sufficient to establish fiduciary duty between the principal and subagent.[124] Although this duty can indeed be modified by contract,[125] specialists do not have contracts with their public customers that relieve them of any fiduciary duties.[126]

Prior to the specialist prosecutions, there was the 1993 case of *Market Street Limited Partners v. Englander Capital Corp.* that held specialists to have the same fiduciary obligations as brokers.[127] The duties of brokers are of best execution, which means getting their customers the best available price.[128] From there, the law gets rather

public on a commission basis. When he does so he is an agent and has a fiduciary obligation to his principal, the purchaser or seller of stock.").

122. *See* Helfhat v. Whitehouse, 179 N.E. 493, 495–96 (N.Y. 1932) (noting that a "contract between a broker and his customer is primarily one of agency," and that "[w]here a broker executes an order through a subagent called a floor broker or *specialist*, the subagent is ordinarily under the same restrictions as the original broker" (emphasis added) (citations omitted)); *see also* Hall v. Paine, 112 N.E. 153, 158 (Mass. 1916) ("A broker's obligation to his principal [seller] requires him to secure the highest price obtainable . . . .").

123. *See Helfhat*, 179 N.E. at 495–96. As noted above, the *Dial* court ruled that brokers were fiduciaries of their customers. *Dial*, 757 F.2d at 168 (citing Marchese v. Shearson Hayden Stores, Inc., 734 F.2d 414, 418 (9th Cir. 1984)).

124. *See* RESTATEMENT (THIRD) OF AGENCY § 3.15(1) (2006); RESTATEMENT (SECOND) OF AGENCY § 428(1)–(2) (1958); RESTATEMENT (FIRST) OF AGENCY § 428 (1933).

125. *See Helfhat*, 179 N.E. at 496 (discussing customs of exchanges that might modify fiduciary duty).

126. Indeed, specialists at the NYSE are bound to put the interests of their customers first, before trading for their own benefit. *See supra* note 36 and accompanying text. Thus, it would be quite hard to conclude that specialists are relieved by contract of fiduciary duties to their public customers, if one were inclined to make such an argument. Compare this to the duties of market makers in "dealer markets" such as the National Association of Securities Dealers Automated Quotations (NASDAQ), where market makers actually publish the prices at which they will agree to buy and sell the securities in which they specialize, putting their customers on notice that the market maker will be between (i.e., interposed themselves between) the buyer and the seller of a security, and capture the difference in prices. *See* Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 268 (3d Cir. 1998) (en banc).

127. Mkt. St. Ltd. Partners v. Englander Capital Corp., No. 92 CIV. 7434 (LMM), 1993 WL 212817, at *9 (S.D.N.Y. June 14, 1993) (citing *Helfnat*, 179 N.E. at 496; Note, *supra* note 121, at 697).

128. *Newton*, 135 F.3d at 270; United States v. Dial, 757 F.2d 163, 168 (7th Cir. 1985) (citing Marchese v. Shearson Hayden Stone, Inc., 734 F.2d 414, 418 (9th Cir. 1984)); *Mkt. St.*, 1993 WL 212817, at *9 (citing Fustok v. Conticommodity Servs. Inc., 618 F. Supp. 1082, 1088 (S.D.N.Y.1985)).

muddled. The Second Circuit, in *De Kwiatkowski v. Bear, Stearns & Co.*, stated that a broker has no general fiduciary duty to advise clients about developments in stock prices unless the broker has been given discretion to control a customer's account by the customer.[129] There appears to be some confusion over whether brokers are fiduciaries under New York law,[130] but the confusion is one between kinds of fiduciary duties.[131] It is the difference between the duty to carry out a requested transaction, which is a fiduciary duty, and the duty to report the underlying business-information for that transaction, which is not a fiduciary duty that brokers owe to their customers.[132] Therefore, though a broker does not owe a fiduciary duty of updating the customer about business developments, a broker does owe a fiduciary duty of best execution.[133] While on the topic of establishing agency, it is worthwhile to note that compensation is not a necessary requirement for the creation of agency.[134] Rather, agency is created when a principal consents for an agent to act on her behalf, the agent also consents to this, and the principal retains control over the agent.[135]

2. Fiduciary Duties

Agents have two kinds of fiduciary duties: loyalty and care.[136] The duty of loyalty, inter alia, includes three particular duties. First, an agent cannot "acquire a material benefit from a third party in connection with transactions conducted . . . on behalf of the principal."[137] This includes the "secret profits" doctrine that an agent cannot profit from her interaction with a third party through the use of the agent's position of agency.[138] This also includes the doctrine of

129. 306 F.3d 1293, 1302 (2d Cir. 2002).

130. *See* Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 536 (2d Cir. 1999).

131. *See id.*

132. *See id.*

133. *See id.*

134. There is no requirement that an agent be paid. There need only be agreement between an agent and principal that the agent shall act on behalf of the principal. RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).

135. *Id.*

136. *See id.* §§ 8.01, 8.08 (noting duties "to act loyally" and "to act with [] care," "[s]ubject to any agreement with the principal").

137. *Id.* § 8.02.

138. *See* Reading v. The King, (1948) 2 K.B. 268, 275 (U.K.) ("[If] the position which [the agent] occupies [is] the real cause of his obtaining the money, as distinct from being a mere opportunity of getting it . . . then he is accountable for it to the [principal]. . . . It is a case where the servant has unjustly enriched himself by virtue

"corporate opportunity," that an agent who receives a business opportunity that both she and her principal might take should not take it upon herself to decide whether the employer should take the opportunity.[139] Second, there is the duty "not to use . . . confidential information of the principal for the agent's own purposes."[140] This is a restatement of the holding of *O'Hagan*.[141] Third, there is a duty on the part of an agent not to serve more than one principal in the same transaction, without those principals' consent.[142] Similarly, the correct course of action for an agent faced with either secret profits or an opportunity that rightfully belongs to the principal is to disclose to the principal the nature of the situation and let the principal make the final decision.[143]

One interesting point in conjunction with specialists and brokers is the problem of a fiduciary having two conflicting principals. The *Restatement (Third) of Agency* allows this configuration to exist, but only when both principals know that their agent is working for them both at the same time.[144] The agent is to communicate all relevant information to her principals[145] and must resign her position as agent

---

of his service *without his master's sanction*." (emphasis added)); RESTATEMENT (THIRD) OF AGENCY § 8.02 cmt. b (2006); *cf.* Jerlyn Yacht Sales, Inc. v. Wayne R. Roman Yacht Brokerage, 950 F.2d 60, 63–64, 67 (1st Cir. 1991) (noting that a broker's non-disclosure of a rebate, who was seller, was a "secret profit").

139. RESTATEMENT (THIRD) OF AGENCY § 8.02 cmt. d (2006); *cf.* Gen. Auto. Mfg. Co. v. Singer, 120 N.W.2d 659, 663 (Wis. 1963) (discussing the corporate opportunity doctrine in relation to an agent's duty to not take opportunities that are sent to the principal).

140. RESTATEMENT (THIRD) OF AGENCY § 8.05(2) (2006).

141. *See id.* § 8.05 reporter's note c (citing United States v. O'Hagan, 521 U.S. 642 (1997)); *supra* note 116 and accompanying text.

142. RESTATEMENT (THIRD) OF AGENCY § 8.06(2)(b) (2006).

143. An act that would otherwise violate the duties of loyalty is allowable if the principal consents, which requires the agent to disclose all material facts. *Id.* § 8.06(1)(a)(ii) (an agent must "disclose[] all material facts that the agent knows, has reason to know, or should know would reasonably affect the principal's judgment unless the principal has manifested that such facts are already known by the principal or that the principal does not wish to know them," in order to obtain the principal's consent for an action that would otherwise be a violation of the duty of loyalty); *see* United States v. O'Hagan, 521 U.S. 642, 652 (1997) (noting "undisclosed, self-serving use of principal's information"); Gen. Auto. Mfg. Co. v. Singer, 120 N.W.2d 659, 663 (Wis. 1963) ("Rather than to resolve the conflict of interest between his side line business and [the principal's] business in favor of serving and advancing his own personal interests, [the agent] had the duty to exercise good faith by disclosing to [the principal] all the facts regarding this matter.").

144. RESTATEMENT (THIRD) OF AGENCY § 8.06(2)(b)(i) (2006); *accord* RESTATEMENT (SECOND) OF AGENCY § 392 (1958).

145. RESTATEMENT (THIRD) OF AGENCY § 8.06(2)(b)(ii) (2006).

if her duties to one principal prevent her from revealing information to another principal that the latter would reasonably want to know in a given transaction.[146] Yet, an agent is not expected to reveal the reservation prices[147] of one principal to another, because that information *is* confidential.[148]

But, while reservation prices may be confidential, bid and offer prices are not (even if they are still non-public): an agent is expected to reveal the bid and offer prices of two adverse parties to each other.[149] In *Jerlyn Yacht Sales, Inc. v. Wayne R. Roman Yacht Brokerage*, the First Circuit, applying Massachusetts law, held that where an agent first failed to tell the buyer that his seller would indeed accept a bid for $800,000, and then, when the buyer raised the bid to $850,000, the agent failed to tell the seller of the raised bid and captured the difference for himself, there was a potential breach of fiduciary duty.[150] The fiduciary duty was owed to both the seller and the buyer.[151] The corollary is that the agent had a duty to disclose to his two principals, the buyer and the seller, their respective bid and offer prices.[152]

F. Economic Terminology and a Dose of Legal Realism:

146. *See id.* §§ 8.03 cmt. b, 8.06 cmt. d(2).

147. The reservation price is the highest price that a buyer is willing to pay, or the lowest price that a seller is willing to collect. *Reservation Price,* NEGOTIATION EXPERTS, http://www.negotiations.com/definition/reservation-price/ (last visited Feb. 15, 2013); *cf.* THE MIT DICTIONARY OF MODERN ECONOMICS 374 (David W. Pearce ed., The Macmillan Press 4th ed. 1992) (1981) (defining a reservation wage as the lowest wage that an employee might take).

148. Hirsch v. Schwartz, 209 A.2d 635, 639 (N.J. 1965) (quoting RESTATEMENT (SECOND) OF AGENCY § 392 cmt. b (1958)).

149. Jerlyn Yacht Sales, Inc. v. Wayne R. Roman Yacht Brokerage, 950 F.2d 60, 67–68 (1st Cir. 1991).

150. *Id.* The procedural posture of the case was an appeal over a jury instruction. The court did not consider whether there was a breach of fiduciary duty because the jury had to decide whether the $50,000 price difference was a material fact that the seller or buyer might have cared about. *See id.* at 68–69. The plaintiffs were the buyer *and* the seller, while the defendant was the broker. *Id.* at 61–62.

151. *See id.* at 68 ("Plainly it was an open question whether [the agent] did not violate this principle [the duty to abstain from secret profits] here when (a) he may have concealed from [the buyer] information that [the seller] had accepted the former's $800,000 offer, and (b) he faxed the $800,000 agreement to [the seller] for signature without advising [the seller] that [the buyer] had, in fact, raised his offer to $850,000.").

152. *See id.* (noting that the broker could have carried out his duty if he had disclosed to the parties either their actual bid and offer or his intent to take a higher commission than initially agreed upon); RESTATEMENT (THIRD) OF AGENCY § 8.06(2)(b)(ii) (2006).

Arbitrage and Rent

Finally, it is worthwhile to consider specialist interpositioning as it affects the wider economy. The late Professor Lon Fuller argued that laws exist to solve problems: there is a nexus between formal doctrines and the social problems that they address.[153] All legal rules, therefore, can be defined through their associated problems.[154] This was so, argued Professor Fuller, because though legislators could not foresee every possible outcome or problem, they could think about concepts, which could take different shapes with a constant, common element.[155] Hence, to fully evaluate the practice of interpositioning from Professor Fuller's partially Legal Realist perspective,[156] one ought to have some idea of the economic nature of the activities that are prohibited by the anti-fraud provisions of Rule 10b-5, compared with other similar but beneficent economic activities.

Interpositioning has been called a form of arbitrage.[157] Arbitrage is

> [a]n operation involving simultaneous purchase and sale of an asset, e.g. a commodity or currency, in two or more markets between which there are price difference or discrepancies. The arbitrageur aims to profit from the price difference; the effect of his action is to lessen or eliminate the price difference.[158]

It is often argued that arbitrage is socially beneficial because it leads the price of a good or asset to be the same in two different markets, avoiding the inefficiency of a good being over- or under-valued anywhere.[159]

---

153. For example, Professor Fuller argued that were society to erase the doctrine of consideration from the law, society's solution to the problems that the doctrine addressed would probably take a similar form to that doctrine. *See* Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799, 824 (1941).

154. *See id.*

155. Lon L. Fuller, *American Legal Realism*, 82 U. PA. L. REV. 429, 446–47 (1934).

156. Professor Fuller did not consider himself a proper Legal Realist because of his view that legal concepts had value, compared with the view that he ascribed to Karl Llewellyn, that legal concepts had no value. *See id.* at 443–44.

157. *Finnerty III*, 533 F.3d 143, 145 (2d Cir. 2008).

158. THE MIT DICTIONARY OF MODERN ECONOMICS, *supra* note 147, at 17.

159. E. Glen Weyl, Is Arbitrage Socially Beneficial? (Oct. 2007) (unpublished manuscript), *available at* http://home.uchicago.edu/weyl/Second_Draft_Arbitrage.pdf. Arbitrage is something that is impossible in a general equilibrium. *See* Leonidas C. Koutsougeras & Konstantinos G. Papadopoulos, *Arbitrage and Equilibrium in Strategic Security Markets*, 23 ECON. THEORY 553, 553–54 (2004) (explaining that arbitrage is only possible in markets where there is no equilibrium). A general equilibrium is when prices have set in and do not change because they are perfect for an economic system. THE MIT DICTIONARY OF MODERN ECONOMICS, *supra* note 147, at 169.

Another potentially useful economic term for this discussion is economic rent. Economic rent is "[a] payment to a factor in excess of what is necessary to keep it to its present employment."[160] Rent is generally considered an undeserved income (the earner has done nothing to earn it), in that if the income were removed (or, rather, the portion of it that is economic rent) the earner would not stop her activity, if any.[161] The nineteenth century economist David Ricardo explained that rent is essentially what is paid for that which would happen with or without that payment, using the example of timber that might grow in Norway.[162] Ricardo distinguished the price paid for removing trees from Norway, the payment for the wages of the movers and also the rarity of the product, from payment for the ability to grow trees; for trees would always grow, regardless of whether anyone was paid.[163] The corollary is that rent is essentially windfall income, such as when a landlord takes income for the fact that she owns a field on which trees grow, despite the fact that the trees would grow there with or without that landlord, or any landlord.[164] In other words, rent is income associated with a legal position rather than income due to some form of production—it is a pure wealth transfer between the person owning the property and the person interested in making use of it, rather than payment for a good or service.[165]

Where there is rent, there is another phenomenon called rent-seeking, whereby individuals seek the windfall that is rent.[166] The

160. THE MIT DICTIONARY OF MODERN ECONOMICS, *supra* note 147, at 121. A definition better grounded in the origin of the term is the excess of what a factor receives not over what is necessary to keep it to its current employment but over any employment. *See id.* For a general discussion of these two different conceptions of economic rent, see A. Ross Shepherd, *Economic Rent and Industry Supply Curve*, 37 S. ECON. J. 209 (1970). All references to 'rent' or 'economic rent' are interchangeable; this Note does not deal with the "rent" that landlords take from their tenants.

161. *See* MIT DICTIONARY OF MODERN ECONOMICS, *supra* note 147, at 121 (implying that a laborer that receives a rent wage would remain employed even if it were taken away).

162. *See* DAVID RICARDO, ON THE PRINCIPLES OF POLITICAL ECONOMY AND TAXATION 33–34 (J.M. Dent & Sons 1911) (1817).

163. *See id.* (distinguishing between the "liberty of removing and selling the timber" from "the liberty of growing it").

164. *Cf. id.*

165. Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 W. ECON. J. 224, 229 (1967).

166. *See* Anne O. Krueger, *The Political Economy of the Rent Seeking Society*, 64 AM. ECON. REV. 291, 302–03 (1974) (discussing rent in the form of import licenses).

existence of rent leads individuals to expend their economic resources to have the right to those rents (to that windfall income), rather than expand economic resources on producing wealth.[167] A good example is given by Professor Gordon Tullock, who shows that in a pure transfer of wealth situation, individuals will spend resources on attempting to either prevent or bring about the wealth transfer.[168] Specifically, thievery is a wealth transfer.[169] And, just as a thief will expend resources to get thieving equipment, so too will individuals pay for the police, courts, and locks to prevent the thief from "transferring" wealth away from them.[170] The end cost is that instead of using its resources to produce something else, society winds up spending resources to prevent something from happening, while the thief, instead of producing something, spends resources to take something from someone else.[171] Rent-seeking, where parties compete with each other to capture rent income, has essentially the same effect: rather than expanding resources to produce, people expend resources in order to compete with each other for rent income.[172]

With this background it will be possible to appreciate the real economic nature of interpositioning.[173]

II. THE CONFLICT: THE COURTS' AND THE GOVERNMENT'S ANALYSES OF INTERPOSITIONING AND FRAUD

On the one side, the court decisions that culminated with *Finnerty III*[174] ruled that specialists' interpositioning was not a fraud in violation of Rule 10b-5.[175] On the other, the government tried to make a case that specialists were agents of their customers, owed fiduciary duties to those customers, and by breaching those fiduciary

167. *See* James M. Buchanan, *Rent Seeking, Noncompensated Transfers, and the Laws of Succession*, 26 J. L. & ECON. 71, 83 (1983) ("By contrast, rent seeking is socially inefficient because the process in itself creates no value while utilizing scarce resources."); Krueger, *supra* note 166, at 295 (explaining the difference between trade tariffs and import licenses from the perspective of rent-seeking).

168. Tullock, *supra* note 165, at 229–31.

169. *See id.* at 228.

170. *See id.* at 229–31.

171. *See id.*

172. *Cf.* Krueger, *supra* note 166, at 301–03.

173. For a discussion of whether and how interpositioning fits into these economic categories, see *infra* Part III.A.

174. 533 F.3d 143 (2d Cir. 2008).

175. *Id.*

duties had committed fraud.[176] Before any of the prosecutions went to trial, the SEC and the NYSE decided that interpositioning was simply deceptive, and thereby fraud, without reaching the question of fiduciary duty.[177]

A. The Logic of the Courts

There are five reported court decisions that discuss the specialist prosecutions. In the beginning, there were three similar motions to dismiss where the courts first looked at the sort of evidence that would be needed to make the government's case: *United States v. Bongiorno*,[178] *United States v. Hunt*,[179] and *Finnerty I*.[180] Then came Finnerty's motion to set aside his guilty verdict, *Finnerty II*.[181] Finally came the government's appeal of the District Court's decision to set aside Finnerty's conviction, *Finnerty III*.[182]

At the motion to dismiss stage, the *Bongiorno*, *Hunt*, and *Finnerty I* courts separated Rule 10b-5 into its three prongs and held that violations of prongs (a) and (c), prohibiting fraud, could be proved at trial by the government.[183] At this point, the courts agreed that, in principle, interpositioning *could be* found to be a form of fraud because customers likely did not expect that their trades would not be getting the best price, when the rules of the exchanges spoke to the contrary.[184]

But, the *Bongiorno* court ruled that even if specialists did owe a fiduciary duty of best execution to their customers, as do brokers, a

176. *See, e.g.*, Government's Memorandum of Law in Opposition to Defendant's Pretrial Motions at 13–16, United States v. Hunt, No. 05 CR. 395(DAB), 2006 WL 2613754 (S.D.N.Y. Sept. 6, 2006), 2006 WL 5149675 [hereinafter Government Memorandum in *Hunt*].

177. *E.g.*, Fleet Specialist, Inc., Exchange Act Release No. 34-49499, 82 SEC Docket 1895, at *2, 8 (Mar. 30, 2004); *see* Bear Wagner, Inc., New York Stock Exchange Hearing Panel Decision 04-51, ¶¶ 29–30 (Mar. 29, 2004).

178. No. 05 Cr. 390(SHS), 2006 WL 1140864 (S.D.N.Y. May 1, 2006).

179. No. 05 CR. 395(DAB), 2006 WL 2613754 (S.D.N.Y. Sept. 6, 2006).

180. Nos. 05 Cr. 393 DC, 05 Cr. 397 DC, 2006 WL 2802042 (S.D.N.Y. Oct. 2, 2006).

181. *Finnerty II*, 474 F. Supp. 2d 530 (S.D.N.Y. 2007).

182. *Finnerty III*, 533 F.3d 143 (2d Cir. 2008). As a result of this decision, two other specialist convictions were overturned, without any extra discussion of the merits of the case. *See United States v. Hayward*, 284 F. App'x 857 (2d Cir. 2008).

183. *Finnerty I*, 2006 WL 2802042, at *4–5; *Hunt*, 2006 WL 2613754, at *4; *Bongiorno*, 2006 WL 1140864, at *5–6.

184. *Finnerty I*, 2006 WL 2802042, at *5 (citing *Bongiorno* 2006 WL 1140864, at *6–7); *Hunt*, 2006 WL 2613754, at *4 (citing *Bongiorno*, 2006 WL 1140864, at *6–7); *Bongiorno*, 2006 WL 1140864, at *6–7.

violation of such a duty does not rise to a fraud, and therefore could not, in and of itself, constitute a deception.[185] The court added that, without a statement that was itself made misleading or deceptive by an omission, an omission (a failure to do something) could not be the basis of fraud.[186] The *Finnerty I* court adopted the reasoning of the *Bongiorno* court, agreeing that even if specialists did have a fiduciary duty to their customers, its violation, without a misstatement or a statement that was made deceptive by an omission, was not a Rule 10b-5 violation.[187] In other words, both courts ruled that the specialists' failure to get the best price for their customers was not deceptive because they had never promised any such thing.

The next case was *Hunt*, where the court agreed with the above[188] analysis in *Bongiorno* and *Finnerty I*,[189] but went further by denying that specialists had any fiduciary duty at all.[190] Specifically, the court construed New York law to state that brokers owed no fiduciary duty when they had no discretion over customers' accounts and acted only to effect customers' orders, citing *De Kwiatkowski*, among others.[191] Since brokers owed no fiduciary duty to their customers, neither did specialists.[192] Thus, the court was able to follow the precedent of an earlier case, *Market Street*, without following its conclusion,[193]

185. *Bongiorno*, 2006 WL 1140864, at *7–8.

186. *See id.* at *8–9.

187. *Finnerty I*, 2006 WL 2802042, at *6–7 (citing *Bongiorno*, 2006 WL 1140864, at *8–9). The *Finnerty I* court also rejected the argument that what Finnerty did was analogous to over-charging by brokers for securities, because unlike brokers, specialists do not solicit their customers. *Id.* at *6 (citing Grandon v. Merrill Lynch & Co., 147 F.3d 184, 192 (2d Cir. 1998)).

188. *See supra* notes 185–87 and accompanying text.

189. *See Hunt*, 2006 WL 2613754, at *4.

190. *See id.* at *5–6.

191. *See id.* (citing De Kwiatkowski v. Bear, Stearns & Co., 306 F.3d 1293, 1308–09 (2d Cir. 2002); Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 536 (2d Cir. 1999); Bissel v. Merrill Lynch & Co., 937 F. Supp. 237, 246 (S.D.N.Y. 1996)).

192. *See id.* (rejecting the argument that specialists owe a fiduciary duty to their customers).

193. *Market Street* stood for the proposition that specialists owe the same fiduciary duty to their customers that brokers owe to their customers. Mkt. St. Ltd. Partners v. Englander Capital Corp., No. 92 CIV. 7434 (LMM), 1993 WL 212817, at *9 (S.D.N.Y. June 14, 1993) (citing Helfhat v. Whitehouse, 179 N.E. 493, 496 (N.Y. 1932)); *see also supra* note 127 and accompanying text (discussing *Market Street*). And, the court also noted that brokers *did* have a fiduciary duty to their customers. *Id.* (citing Fustok v. Conticommodity Servs., Inc., 618 F. Supp. 1082, 1088 (S.D.N.Y. 1985)). Thus, the court concluded that specialists had a limited fiduciary duty. *See id.* The apparent conflict between *Market Street* on one side, and *Hunt* and *De Kwiatkowski* on the other, is discussed in Part III.B, *infra*.

resulting in the holding: even if specialists had the same fiduciary duties as brokers, *neither* had a fiduciary duty to their customers.[194]

The court also noted that because specialists had to execute both buy and sell orders that met in the middle, at the specialists trading desk,[195] if a specialist owed a fiduciary duty to anyone, she would owe it to both buyer and seller, implying that this was another reason that specialists could not be said to owe a fiduciary duty to their customers.[196] The court then distinguished *Market Street* on the ground that specialists in the earlier case were paid, while, in *Hunt*, the government did not allege that specialists received compensation from their customers.[197] Finally, the court noted that even if there were a breach, and if mere omissions could be fraud, the government's case would be circular because the only omission that the government could pin on the defendants was that they omitted to state a breach of fiduciary duty.[198] The court found the argument that a disclosure duty could be breached by failing to mention that one was breaching that disclosure duty to be circular.[199]

After the *Bongiorno*, *Hunt*, and *Finnerty I* cases had their motions to dismiss denied,[200] a jury convicted Finnerty of a violation of Rule 10b-5, but the court set that verdict aside.[201] The court explained that the defendant could not be convicted when the government had not proven a violation of any of the prongs of Rule 10b-5.[202] Specifically, the court explained that although prongs (a) and (c) could have been proven by fraud, this required some proof of what customers had actually expected of the specialists, while the government had only furnished proof of what the defendant knew he had to do—there was

194. *See Hunt*, 2006 WL 2613754, at *5 ("'[A] specialist has fiduciary obligations closely resembling, if not identical to, those of a broker.' However, stockbrokers generally do not owe a fiduciary duty unless a customer has delegated discretionary trading authority to that broker." (quoting *Bongiorno*, 2006 WL 1140864, at *7) (citing *De Kwiatkowski*, 306 F.3d at 1308–09)).

195. *See supra* note 25 and accompanying text.

196. *See Hunt*, 2006 WL 2613754, at *6 ("[S]pecialists have no loyalty to buyers and sellers as they execute orders for both . . . .").

197. *See Hunt*, 2006 WL 2613754, at *6.

198. *Id.* at *7.

199. *See id.*; *cf.* RESTATEMENT (THIRD) OF AGENCY § 8.06 (stating that an action that would have otherwise breached a duty, would not be a breach if the principal had been informed in advance and consented to the action).

200. *See supra* notes 178–180.

201. *Finnerty II*, 474 F. Supp. 2d 530 (S.D.N.Y. 2007), *aff'd*, 533 F.3d 143 (2d Cir. 2008).

202. *See id.* at 539–40.

no proof that Finnerty's customers knew that they were supposed to be getting the best price for their orders, in line with NYSE rules.[203] In its discussion of the utter lack of proof of customer expectations, the court appeared to be quite angry that it and the jurors felt left out of the loop:

> What, if any, understanding did customers have as to a specialist's obligations? What did customers expect when presenting an order to the specialist? What did customers "trust" the specialists to do? Did customers even know that a specialist could trade for his proprietary account? Did customers assume that the specialist was providing services without charge? Or did customers know that the specialist was trading for his own account and making a profit? Did customers believe that they would get the best possible price and, if so, what was the basis for that belief? Would customers have thought they had been deceived upon learning that in some trades, where they bought or sold within their limits or at market price, the specialist made a profit of a few cents a share for the proprietary account?
>
> Some of the answers to these questions may be obvious to those with knowledge of the industry, but none of these questions were answered by the evidence presented at trial.[204]

The court then went on to adopt two parts of the *Hunt* analysis of fiduciary duty, to put aside the theory that by taking money from his customers in violation of a fiduciary duty, Finnerty had committed fraud.[205] In particular, the *Finnerty II* court picked up on the idea that a specialist would have two principals, if any, and concluded that specialists therefore could not have any principals.[206] And, in a footnote, the court adopted the idea that since specialists were not paid—or that since the government had not proved how, if at all, specialists were paid—the case was distinguishable from *Market Street*, which held that specialists were fiduciaries of their customers.[207]

203. *See id.* at 540–42.

204. *Id.* at 541–42; *see also* Colesanti, *supra* note 23, at 28–29 (noting the *Finnerty* court's frustration on this matter).

205. *See Finnerty II*, 474 F. Supp. 2d at 543–44 & n.10 (citing *Hunt*, 2006 WL 2613754, at *6).

206. *See id.* at 543–44 (citing *Hunt*, 2006 WL 2613754, at *6).

207. *See id.* at 544 n.10 (citing *Hunt*, 2006 WL 2613754, at *6).

The last judicial opinion on interpositioning came with the appeal of the *Finnerty II* decision to the Second Circuit, *Finnerty III*.[208] In *Finnerty III*, the Second Circuit approached a narrowed argument, for the government no longer attempted to argue fiduciary duty.[209] Rather, the government argued only that Finnerty's actions were deceptive and that the evidence at trial proved this.[210] The Second Circuit ruled that there was insufficient evidence to show that Finnerty had personally misled anyone.[211] In passing, the court stated that it seemed that the government had proven some manner of theft by Finnerty but that without a showing of fiduciary duty, there could be no fraud in that.[212] The court suggested that conduct, such as theft, could be deceptive, but only rose to the level of fraud if there were a breach of fiduciary duty accompanying the theft.[213] The court ended with two points. First, the government could not prove a violation of customer expectations by pointing to the rules of the NYSE and stating that Finnerty violated those; there had to be some deception emanating from Finnerty himself.[214] Second, the government could not argue that a violation of exchange rules was a violation of the securities laws.[215]

B. The Counter-Argument

As noted above, the government gave up the argument that specialists owed a fiduciary duty by the time the *Finnerty* case got to

208. *See Finnerty III*, 533 F.3d 143 (2d Cir. 2008). This decision was quickly copied and pasted to overturn the convictions of two other specialists who had been convicted. *See* United States v. Hayward, 284 F. App'x 857, 858 (2d Cir. 2008).

209. Reply Brief for the United States of America at 22, *Finnerty III*, 533 F.3d 143 (2d Cir. 2008) (No. 07-1104-CR), 2008 WL 6610969.

210. *Id.* at 10–27.

211. *See Finnerty III*, 533 F.3d at 149.

212. *See id.* at 148 (citing *In re* Refco Capital Mkts., Ltd. Brokerage Customer Sec. Litig., No. 06 Civ. 643(GEL), 2007 WL 2694469, at *8 (S.D.N.Y. Sept. 13, 2007)). *Refco Capital*, in turn, cited *SEC v. Zandford*, 535 U.S. 813, 823 (2002) (citing *Chiarella v. United States*, 445 U.S. 222, 230 (1980) (noting that purchases of securities that show a breach of fiduciary duty and are undisclosed to the principal are fraud and therefore deceptive)). *See also supra* Part I.C.

213. *See Finnerty III*, 533 F.3d at 148 (citing Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 158-59 (2008); *Refco Capital*, 2007 WL 2694469, at *8).

214. *Id.* at 149–50 (citing Lattanzio v. Deloitte & Touche LLP, 476 F.3d 147 (2d Cir. 2007)).

215. *Id.* at 150–51 (citing Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971)).

the Second Circuit.[216] At the trial stage, the government had argued that specialists did owe a duty to their public customers.[217] The government tried to argue that specialists owed a duty of best execution to their customers.[218] Specialists have the same duties as brokers and, therefore, specialists owe a duty of best execution: to obtain the best possible price for their customers.[219] Therefore, a specialist's failure to disclose her failure to get the best price for her customer was a violation of Rule 10b-5.[220] The government similarly argued that interpositioning was a fraudulent scheme, and therefore a violation of Rule 10b-5 subsections (a) and (c).[221]

Even before the issue went to the federal courts, the SEC found that interpositioning had violated Rule 10b-5.[222] Unfortunately, as these were settlement proceedings,[223] the SEC did not undertake

216. *See* Reply Brief, *supra* note 209, at 22.

217. *See* Government Memorandum in *Hunt*, *supra* note 176, at 13–15. The government argued that specialists have a fiduciary duty to their public customers in an identical way in all of the specialist prosecutions. *C.f, e.g.*, Government's Memorandum of Law in Opposition to Defendants' Pretrial Motions at 14–17, *Finnerty I*, Nos. 05 Cr. 393 (DC), 05 Cr. 397 (DC) (S.D.N.Y. June 16, 2006), 2006 WL 4793068.

218. *See, e.g.*, Government Memorandum in *Hunt*, *supra* note 176, at 13–15 (citing Newton v. Merrill Lynch Fenner & Smith, Inc., 135 F.3d 266, 269 (3d Cir. 1998) (en banc); Mkt. St. Ltd. Partners v. Englander Capital Corp., 1993 WL 212817, at *9 (S.D.N.Y. June 14, 1993)).

219. *See, e.g.*, *id.*

220. *See, e.g.*, *id.* at 15–16 (citing Chiarella v. United States, 445 U.S. 222, 228 (1980)). The distinction between an ordinary breach of fiduciary duty and a violation of Rule 10b-5 was that the latter was deceptive. *See, e.g.*, *id.* at 18.

221. *See, e.g.*, *id.* at 11–12.

222. *E.g.*, Fleet Specialist, Inc., Exchange Act Release No. 34-49499, 82 SEC Docket 1895, at *2, 8 (Mar. 30, 2004); Van Der Moolen Specialists USA, LLC, Exchange Act Release No. 34-49,502, 82 SEC Docket 1920, at *2, 7–8 (Mar. 30, 2004), 2005 WL 626564.

223. *E.g.*, Fleet Specialist, Inc., 82 SEC Docket 1895, at *1 n.1 ("The findings herein are made pursuant to [Fleet Street's settlement] Offer and are not binding on any other person or entity in this or any other proceeding."); Van Der Moolen Specialists USA, LLC, 83 S.E.C. Docket 2366, at *1 n.1 ("The findings herein are made pursuant to [Van Der Moolen's settlement] Offer and are not binding on any other person or entity in this or any other proceeding."). The SEC has the power to settle cases before they reach final adjudication before an administrative law judge; these settlements produce opinions called Consent Judgments. *See* U.S. S.E.C. v. Citigroup Global Mkts., Inc., 673 F.3d 158, 161–62 (2d Cir. 2012) (citing U.S. S.E.C. v. Citigroup Global Mkts., Inc., 827 F. Supp. 2d 328, 335 (S.D.N.Y. 2011)) (discussing the practice of the SEC to settle the majority of its administrative adjudications). In Consent Judgments, the party charged neither admits nor denies wrongdoing, but agrees to pay a stiff fine. *Id.* Regardless of what the SEC says may have happened, the party charged does not admit anything, and the decision is not binding on any other party; hence, these Consent Judgments have no precedential value. *See id.*

much of a legal analysis of the situation. The NYSE undertook a similar action and also found a violation of Rule 10b-5.[224] The SEC and the NYSE found deception, and thus fraud, in the actions of specialists being the lynch pin of a Rule 10b-5 violation by stating:

> [s]pecialists impliedly represent to their customers that they are dealing fairly with the public in accordance with the standards and practices applicable to specialists, namely, that they are limiting their dealer transactions to those "reasonably necessary to maintain a fair and orderly market." A specialist's failure to comply with this implied representation, if done with *scienter*, can constitute a violation of the antifraud provisions of the securities laws.[225]

There was no mention of fiduciary duty in these decisions.

Some commentators have agreed that specialists are fiduciaries of their customers. A student note predating the interpositioning prosecutions states that when a specialist is trading on behalf of a customer, she has a fiduciary duty to that customer.[226] Another commentator suggests that the government's case "exhibited a few prosecutorial shortcuts and presumptions," and simply failed to show deception.[227] Nevertheless, he notes that "the [s]pecialist as agent broker would still arguably owe a fiduciary duty to the public customer."[228]

Finally, in an ongoing class action against specialists, the Southern District of New York suggested that knowledge by specialist firms of their employees' interpositioning was sufficient to show scienter on

224. Bear Wagner, Inc., New York Stock Exchange Hearing Panel Decision 04-51, ¶¶ 5, 38, 40, 42 (Mar. 29, 2004), *available at* http://www.nyse.com/pdfs/04-051.pdf.

225. *Fleet Specialist, Inc.*, 2004 WL 626580, at *8 (citing Newton v. Merrill Lynch Pierce Fenner & Smith, Inc., 135 F.3d 266 (3d Cir. 1998) (en banc); Mkt. St. Ltd. Partners v. Englander Capital Corp., No. 92 CIV. 7434 (LMM), 1993 WL 212817 (S.D.N.Y. June 14, 1993)); Van Der Moolen Specialists USA, LLC, Exchange Act Release No. 49502, 2004 WL 626564, at *8 (Mar. 30, 2004) (citing the same sources); Bear Wagner, Inc., New York Stock Exchange Hearing Panel Decision 04-51, ¶ 40 (citing the same sources). All three of these sources have the same paragraph, verbatim. For a discussion of why the SEC's view that interpositioning constituted fraud because it entailed deception was not accorded any deference, see *supra* note 60.

226. *See* Note, *supra* note 121, at 697. This discussion, nevertheless, was not about interpositioning, but rather about the ability of specialists to engage in old-fashioned insider trading because of their greater access to corporate inside information, due to their positions as traders of those companies' stocks. *See id.* at 697–99.

227. *See* Colesanti, *supra* note 23, at 27.

228. *See id.* at 26 (citing *Mkt. St.*, 1993 WL 212817, at *31, 33).

the part of the firms.[229] The court added also that the clients of the specialists could rely on "honesty and integrity of the NYSE."[230] Only time will tell whether the class is able to prove that the specialists committed fraud by interpositioning[231]—unless there is a settlement before that, which is likely as settlement negotiations are ongoing.[232] The class does not appear to be arguing that the specialists had any fiduciary duties to the class, as agents of the class.

III. WHO'S RIGHT?

The outcome of the specialist prosecutions appears to be based on a misunderstanding of the law of agency.[233] Yet, the courts' mistakes can be excused by the incomplete analysis of fiduciary duty given by the prosecution, who did not deal with the nuance that specialists' fiduciary duties are multi-dimensional. Specifically, specialists have a duty to get their customers the best price, but do not have a duty to constantly update them with information.[234] Thus, the courts could be excused for taking the absence of one fiduciary duty to mean the total absence of all fiduciary duties.[235]

A. Economic Analysis for Legal Realism

Returning to the ideas of Professor Fuller, discussed in Part I.F,[236] what is the economic nature of interpositioning? Is it a problem of the same kind that Rule 10b-5 exists to prevent, or is it merely beneficent arbitrage? To answer this question, it is useful to consider what sort of economic problem Rule 10b-5 has been shown to address.

229. *In re* NYSE Specialists Sec. Litig., 405 F. Supp. 2d 281, 314 (S.D.N.Y. 2005), *rev'd on other grounds*, 503 F.3d 89 (2d Cir. 2007); *see NYSE Specialists*, 260 F.R.D. at 75 (noting that the lead plaintiff may be able "to identify the Specialist Firms' illegal conduct in a uniform manner and can be used to determine whether illegal conduct occurred without necessitating a trade-by-trade review").

230. *NYSE Specialists*, 405 F. Supp. 2d at 319.

231. *Cf. Finnerty II*, 474 F. Supp. 2d 530, 538–42 (S.D.N.Y. 2007) (discussing the government's failure to prove fraud), *aff'd*, 533 F.3d 143 (2d Cir. 2008).

232. *See supra* note 66.

233. *See* Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 536 (2d Cir. 1999); *supra* notes 130–133 and accompanying text.

234. *See supra* notes 130–133 and accompanying text.

235. *See supra* notes 130–133 and accompanying text.

236. *See supra* notes 153–156 and accompanying text.

Rule 10b-5 combats fraud in connection with the sale or purchase of a security.[237] Fraud, as discussed above, generally takes the shape of swindling someone.[238] Because there is an assumption that an agent acts loyally to the principal, a disloyal agent is tacitly deceptive.[239] The disloyal action is usually done to make profit from the agent's position, without the consent of the principal.[240] Profit comes from information: first, one may fail to tell the principal of some chance to make a profit (these are the secret profit and corporate opportunity doctrines,[241] and both are easily applied to classical insider trading[242]); second, one may use some confidence of the principal without the principal's consent, usually this confidence is about a transaction that shall take place at a given price (the misappropriation theory variety of insider trading falls into this category[243] as does trading ahead[244]).

In either of the above cases, the information relates to a transaction that was not produced by the agent; *it was already taking place*. Rather, the agent was free-riding on this transaction in one of two ways. First, an opportunity was going to the principal because of the nature of the principal's position and the agent decided to take it for herself.[245] Or second, the principal had already decided to act, and

237. *See supra* note 69 and accompanying text.

238. *See supra* notes 70–71 and accompanying text.

239. *See supra* notes 77–79 and accompanying text.

240. *See supra* notes 78–79, 137–140 and accompanying text.

241. *See supra* notes 137–139 and accompanying text.

242. *See supra* notes 107–109 and accompanying text.

243. *See supra* notes 140, 110–116 and accompanying text.

244. *See supra* notes 92•98 and accompanying text.

245. *See supra* notes 241–242 and accompanying text. A potential difficulty arises with the Secret Profits doctrine, since the doctrine extends to *all* activities of an agent that arise as a result of its employment with the principal. *See* Reading v. The King, (1948) 2 K.B. 268, 275 (U.K.) ("It matters not that the master has not lost any profit, nor suffered any damage. Nor does it matter that the master could not have done the act himself. It is a case where the servant unjustly enriched himself by virtue of his service without the master's sanction."). Thus, these may include potentially *new* activities that the principal might not have done on his own. *See id.* However, the fiduciary duty of loyalty does not have to deal *with only one problem*; rather, it can deal with multiple problems, as any legal doctrine. *Cf.* Fuller, *supra* note 153, at 800–04 (listing the various functions that the doctrine of consideration fulfills). Still, one easy example of the secret profits rule is when a broker refuses to report to his principal a commission that he is receiving while watching the principal's property. *See, e.g.*, Little v. Phipps, 94 N.E. 260, 260–62 (Mass. 1911). In such a case, the commission would have come to *someone*; the agent merely captured it, or redirected it from the principal. *See id.*

the agent made an incidental profit.[246] In both of these cases, the agent has added no value but merely profited from an existing productive activity brought about by the principal. The agent's income is economic rent, just as Ricardo described it, when he said that to extract rent is to profit from the timber that grows in Norway that would grow regardless of who, if anyone, owned the land.[247] In other words, the profit to the agent is not necessary for the activity to take place, but the agent profits from it anyway.[248]

Thus, one of the functions of the fiduciary duty of loyalty is to prevent agents from extracting rent from their principals—unless, of course, this is part of the bargain.[249] Fraud, among other things, is the violation of this duty.[250] So, fraud from the violation of the fiduciary duty of loyalty is rent-seeking, and the profit from the fraud is extracted rent. So the problem that Rule 10b-5 addresses is rent-seeking in connection with the purchase or sale of a security.[251]

So, what then of interpositioning? Interpositioning has been called arbitrage,[252] and arbitrage is generally a good thing.[253] But interpositioning is not arbitrage. By definition, arbitrage requires one to find price discrepancies in different markets and then perform the socially useful task of bringing those prices into line with one another.[254] Specialists, on the other hand, do not search out price discrepancies; rather, the price discrepancies come to them without any effort on their part.[255]

When one retains income for something that happens naturally, or at least without input on the part of the one retaining the income, that is called rent.[256] Specialists are already compensated for their work by receiving commissions.[257] The nature of a rent is such that if it were eliminated, the factor that took it would continue to exist,[258] like the

246. *See supra* notes 243–244 and accompanying text.
247. *See supra* notes 161–164 and accompanying text.
248. *See supra* note 165 and accompanying text.
249. *See supra* note 247 and accompanying text.
250. *See supra* notes 238–240 and accompanying text.
251. *See supra* notes 69, 249–250 and accompanying text.
252. *Finnerty III*, 533 F.3d 143, 145 (2d Cir. 2008).
253. *See supra* notes 158–59 and accompanying text.
254. *See supra* notes 158–59 and accompanying text.
255. *See supra* notes 25–28 and accompanying text.
256. *See supra* notes 162–164 and accompanying text.
257. *See supra* notes 38–39 and accompanying text.
258. *See supra* notes 162–164 and accompanying text.

"original and indestructible powers" of the land.[259] This wealth transfer from traders to specialists is not socially useful because it incentivizes customers to spend extra time and resources figuring out what they by definition do not know: the price closest to what a counterparty might offer or bid, rather than putting those resources into some other form of wealth creation.[260]

One might argue that specialists have always understood that part of their income to be interpositioning income and that indeed this is what makes a firm agree to such an arrangement with an exchange.[261] But one cannot agree to something that one does not know occurs, and since no one had sued the specialists' firms before the SEC uncovered interpositioning, customers were simply not aware of interpositioning.[262] Furthermore, how could customers collectively agree to ignore the Rules of the NYSE?[263] More importantly, the existence of the opportunity to profit from rent income in this manner, encourages more entrants into the market than would otherwise be efficient.[264] In other words, financial firms' resources, instead of producing wealth, are extracting wealth transfers from the customers of exchanges.[265] Hence, interpositioning is the extraction of economic rent, and this is precisely the sort of activity that Rule 10b-5 exists to prevent.

B. Mistakes in the Law and a Fact: Fiduciary Duty, Fraud, and Rule 10b-5

The chief flaw in the courts' analyses is that they give short shrift to the issue of fiduciary duty.[266] Their reasoning proceeded as follows:

259. RICARDO, *supra* note 162, at 34.

260. *Cf.* Tullock, *supra* note 165, at 229•31.

261. *Cf.* Krueger, *supra* note 166, at 292–93 (discussing the fact that bribes paid to public servants may be part of the enticement to become public servants). Remember the exasperation of the court in *Finnerty II* about its ignorance of the implied transaction between customers and specialists. *See supra* note 204 and accompanying text.

262. Witness the fact that only one lawsuit was brought by the public against specialists for interpositioning, and only after the SEC uncovered this practice. *See In re* NYSE Specialists Sec. Litig., 503 F.3d 89, 92 (2d Cir. 2007); Lucchetti & Scannell, *supra* note 48, at C1.

263. The Rules of the NYSE prohibited interpositioning. *See supra* note 36.

264. *See* Krueger, *supra* note 166, at 292 (explaining that the existence of rent income in the form of quasi-monopoly profits from import licenses creates a larger number of import firms than is socially useful).

265. *Cf. id.*

266. *See supra* notes 191–197, 205–207 and accompanying text.

for want of fiduciary duty, there was no fraud;[267] for want of fraud, there was no deception;[268] for want of deception, there was no violation of Rule 10b-5[269]—all for the want of fiduciary duty.

The courts made three basic errors with the issue of fiduciary duty. First, the courts incorrectly believed that specialists did not receive a commission from their customers and therefore, were not agents.[270] This analysis erred in two respects. First, specialists are paid, if not directly by customers, then as employees of specialists' firms that receive part of the commission for trades that go through them.[271] Second, compensation is not a necessary condition of agency.[272] Agency is an agreement between the principal and the agent that the latter will act under the control of the former.[273] When a customer orders a broker to buy at a certain price and that broker orders the specialist to do so, *that* is control by a customer. It appears that the reason the courts, particularly that of *Hunt*, made such a lunge at the payment factor was because that was a way to distinguish uncomfortable precedent.[274] But then, payment was not a deciding factor in *Market Street*; in that court's rationale, the term 'commission' only appeared in an explanatory parenthetical quote.[275] Therefore, the *Hunt* court erred, as did the courts that cited it,[276] when it said that because specialists were not paid by their customers—which was not true in the first place—specialists could not be their agents.

267. *See supra* notes 212–213 and accompanying text. For a more accurate discussion of the relation of fiduciary duty and fraud, see *supra* notes 75–79 and accompanying text.

268. *See supra* note 183–184 and accompanying text.

269. *See Finnerty II*, 474 F. Supp. 2d 530, 537 (S.D.N.Y. 2007) ("Thus, the very core of the federal securities laws in question is the premise that there must be some form of deception."), *aff'd*, 533 F.3d 143 (2d Cir. 2008).

270. *See supra* notes 38–40, 197, 207 and accompanying text.

271. *See supra* notes 38–40 and accompanying text. If specialist firms are agents of the customers, and specialists are agents of the firms, then specialists are subagents of the customers, and therefore owe to the customers the same duties as other agents would. RESTATEMENT (THIRD) OF AGENCY § 3.15(1) (2006).

272. *See supra* note 135 and accompanying text.

273. *See id.*

274. *See supra* notes 197, 207 and accompanying text.

275. *See* Mkt. St. Ltd. Partners v. Englander Capital Corp., No. 92 CIV. 7434 (LMM), 1993 WL 212817, at *9 (S.D.N.Y. June 14, 1993) (quoting Note, *supra* note 121, at 697).

276. *See supra* notes 205–207 and accompanying text.

The second, more interesting and bizarre error by the *Hunt* court was the torsion of New York law on the fiduciary duties of brokers.[277] Accepting arguendo that *Market Street* was correct in equating the duties of a specialist to those of a broker, the *Hunt* court bizarrely ruled that brokers do not have any fiduciary duties to their customers anyway.[278] On the one hand, it suggested that it was applying *Market Street* by accepting its analogy of specialists to brokers, but refused to accept its resultant conclusion that because brokers had a fiduciary duty to their customers, so too did specialists, which was the whole point of the analogy.[279] It is not clear why the *Hunt* court did not explicitly disagree with *Market Street* but chose to apply it in this strange way.

On the other hand, the *Hunt* court was plainly misled when it noted that brokers had no fiduciary duties to their customers. Brokers do have a narrow fiduciary duty to their customers, with regard to specific transactions: the duty of best execution.[280] The cases that the *Hunt* court cited stood for the proposition that where a broker had bought a security on behalf of a buyer, that broker did not owe that buyer a duty to keep her informed about price changes in that security.[281] None of those cases actually supported the idea that a broker did not need to get the best possible price for her customer-buyer, even to the detriment of the broker. Perhaps this is why none of the other specialist prosecution cases went quite as far as *Hunt* in that regard. Thus, it must be accepted that brokers do owe a fiduciary duty of best execution to their customers,[282] and therefore, specialists also owe this fiduciary duty to their customers.[283]

Yet, the third and most interesting error with the specialist prosecution cases was the issue of dual principality: that specialists, even if they were agents, would have two adversely positioned principals and that therefore, they would be unable to act as their agents.[284] One suspects that that in the back of their minds neither the courts nor, perhaps, even the government really wanted to deal with the seemingly complex question of what the duties of a specialist are

277. *See supra* notes 191–192 and accompanying text.
278. *See supra* notes 191–194 and accompanying text.
279. *See Mkt. St.*, 1993 WL 212817, at *9 (quoting Note, *supra* note 121, at 697).
280. *See supra* notes 127–133 and accompanying text.
281. *See id.*
282. *See supra* Part I.E.1.
283. *See Mkt. St.*, 1993 WL 212817, at *9 (quoting Note, *supra* note 121, at 697).
284. *See supra* notes 195–196, 206 and accompanying text.

when a specialist must act in the best interest of two parties who are on opposite sides of a transaction. The difficulty was illusory.

An agent may act on behalf of two adversely positioned principals, as long as both principals are informed of this arrangement.[285] There might appear to be difficulty in the agent's need to disclose information "that the agent knows, has reason to know, or should know would reasonably affect the principal's judgment."[286] And, moreover, it is true that an agent whose duty of confidentiality to one principal prevents her from disclosing such information to another principal has a duty to resign her post.[287] Nevertheless, courts have held that an agent acting for two otherwise adverse parties is not required to communicate those two parties' reservation prices nor resign because the agent cannot communicate them.[288] But, where an agent has two principals, she has the duty of informing the adverse parties in a transaction of each other's actual offers and cannot profit from their ignorance of each other's offers.[289] This is precisely what specialists do.[290] Indeed, were one to exchange Finnerty for the broker in *Jerlyn Yacht Sales*, Finnerty would have been found both a fiduciary *and* in violation of his duty to disclose.[291]

A final correction to *Hunt* is that what the court thought was circular—disclosure as the sole duty of a fiduciary[292]—is not actually circular. The confusion stems from the rule that breaches of the duty of loyalty always create a duty to disclose the breach.[293] The full duty of a specialist, then, was either not to engage in interpositioning, by either setting the transaction in securities at either the price of the bid or the price of the offer, *or* by warning her customers that she would interposition.[294] This way, either there would be no interposition, or

285. *See supra* notes 144–45 and accompanying text.

286. *See* RESTATEMENT (THIRD) OF AGENCY § 8.06(2)(b)(ii) (2006).

287. *See id.* § 8.06 cmt. d(2).

288. *See supra* notes 145–148 and accompanying text.

289. Jerlyn Yacht Sales, Inc. v. Wayne R. Roman Yacht Brokerage, 950 F.2d 60, 67 (1st Cir. 1991). See *infra* Part III.D for a discussion of how specialists' duties interact with Rule 10b-5 and § 10(b).

290. *See supra* notes 43–47 and accompanying text.

291. *Compare supra* notes 43–47 and accompanying text (discussing interpositioning), *with supra* notes 149–152 and accompanying text (discussing the duties of a broker between two principals, a buyer and seller with regard to the *Jerlyn Yacht Sale* case).

292. United States v. Hunt, No. 05 CR. 395(DAB), 2006 WL 2613754, at *7 (S.D.N.Y. Sept. 6, 2006) (discussing the government's "puzzlingly circular" theory).

293. *See* RESTATEMENT (THIRD) OF AGENCY § 8.06.

294. *See id.*

the customers would be able to take into account the interpositioning and make bids and offers that at least took interpositioning into account.[295]

C. And All of the Analogies: Insider Trading and Trading Ahead

What makes the courts' decisions so hard to accept is that close analogies to interpositioning abound, and yet go unnoticed by the courts.[296] Interpositioning resembles other fairly standard forms of fraud: modern federal law on insider trading states that a fiduciary of a party that is either acquiring or being acquired in a merger and acquisition has the duty not to trade on the stock of the acquisition target, if the information of the future acquisition is not public.[297] Specialists also have information that is non-public: the bids and offers of the different customers for a security.[298] Reflection on the scenario of *O'Hagan* drives the point home. O'Hagan essentially interposed himself between the buyer of an asset and the seller. He knew that the buyer was going to buy a security, at some price higher than the market price, which was non-public information, and he took advantage of this non-public information to make money on the spread between the current market price and the non-public higher acquisition price.[299] Interpositioning is precisely that—making a profit from the spread between bid and offer prices that are non-public and known only by the specialist because of his fiduciary relationship to the customer.[300] In other words, interpositioning looks like a straightforward case of *O'Hagan*-style misappropriation. And this form of misappropriation fits in neatly with the fiduciary duty not to profit from the principal's property—given that information is a form of property.[301]

295. *See id.*

296. This is, of course, in addition to the similar economic natures of normal 10b-5 fraud and interpositioning, discussed *supra* Part III.A.

297. These are the classical and misappropriation theories of insider trading, respectively. *See supra* notes 106–109 and accompanying text.

298. *See supra* notes 25–28 and accompanying text. If bids and offers sent to specialists were public, specialists would not be able to interposition, since buyers and sellers would change their orders, in an attempt to capture as much of the difference between the bids and offers as possible.

299. *See supra* notes 112–116 and accompanying text.

300. *See supra* notes 43–47 and accompanying text.

301. *See supra* notes 140–141 and accompanying text.

Similarly, interpositioning could be made to look like a classical form of insider trading by shifting the focus to the seller of the asset, whose lack of knowledge about an impending purchase by an acquirer leads her to sell her asset to the insider and lose the ability to sell her asset later at a higher price.[302] Moreover, interpositioning is open to another form of fiduciary duty analysis: the secret profits and opportunity doctrines. The secret profits and opportunity doctrines are, essentially, that an agent is not to derive economic rent from her position of employment.[303] And given that interpositioning is essentially a rent,[304] it is well within the prohibition of the secret profits doctrine.[305]

Lastly, one should consider the similarities between trading ahead, which is fraud,[306] and interpositioning.[307] Trading ahead is to buy a security knowing that one's customer is going to buy it—that is, guaranteeing oneself an asset whose price is set to rise (if the broker buys it before the customer's order is executed).[308] Interpositioning only differs in that, rather than holding onto the security, one simply sells it off to a guaranteed buyer, thus making money from the buyer directly, by sale, rather than indirectly, by allowing the buyer's latter purchase to push up prices.[309] The harm to the final buyer of the security is the same: in both cases, a buyer gets not the price that the market (or another offeror) is offering, but a higher price, while the broker or specialist benefits from being able to have someone else buy a security that creates value for her, either directly or indirectly.[310] The differences between interpositioning and what happened in *Dial* are inapposite, since trading ahead is still a breach of the duty of best

302. *See supra* notes 108–109 and accompanying text.

303. *See supra* notes 137–141, 162–164 and accompanying text. To make money from a third party without actually doing anything except occupying the position of the principal's agent is a textbook example of economic rent. *See supra* notes 162–164 and accompanying text.

304. *See supra* Part III.A.

305. *See supra* note 137 and accompanying text. It is worthwhile to note in the *Jerlyn Yacht Sales* case the fiduciary duty discussed was that relating to secret profits. *See* Jerlyn Yacht Sales, Inc. v. Wayne R. Roman Yacht Brokerage, 950 F.2d 60, 69 (1st Cir. 1991).

306. *See supra* notes 86–87 and accompanying text.

307. *See* Daniel A. Klein, Annotation, *Prosecution Based on Interpositioning, Trading Ahead, or Front Running in Connection with Securities Transaction*, 56 A.L.R. FED. 2d 619 § 6 (2011).

308. *See supra* notes 84–85, 88–90 and accompanying text.

309. *See supra* note 99.

310. *Compare supra* notes 43–48 and accompanying text, *with supra* notes 84–90 and accompanying text.

execution, regardless of whether the broker solicits orders or passively takes them.[311] Since trading ahead is fraud,[312] so too is interpositioning.

D. Of Missing Steps and Synthesis

Of all the specialist prosecution cases, the most complete—if erroneous—analysis of specialists' fiduciary duty was that in *Hunt*.[313] There the court, perhaps, came quite close to finding the flaw in the government's case: "[Rule 10b-5] liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction."[314] The government's argument boiled down to this, since specialists owed a duty to get their customers the best price, they breached this duty by interpositioning, and the failure to disclose this breach was a fraud.[315] The *Hunt* court believed this argument to be circular: how could the sole fiduciary duty of a broker be to disclose its own breach of its fiduciary duty? The *Hunt* court all but said that a mere breach of a fiduciary duty is not securities fraud, unless it is a breach of a duty to disclose.[316] This is true, of course: only breaches of the fiduciary duty of loyalty are fraudulent for the purposes of Rule 10b-5; one must either forgo the breaching activity or disclose its nature to the principal.[317] Breaches of the fiduciary duty of care, on the other hand, do not rise to the level of fraud.[318]

The *Hunt* court's discussion of broker's fiduciary duty was erroneous.[319] The *Hunt* court's authorities for its view[320] stated something quite close to the proposition that brokers had no duties of

311. *Compare* United States v. Dial, 757 F.2d 163, 168 (7th Cir. 1985), *with* Newton v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 135 F.3d 266, 270 (3d Cir. 1998) (en banc), *and* Press v. Chem. Inv. Servs.Corp., 166 F.3d 529, 536 (2d Cir. 1999).

312. *See supra* Part I.D.1.

313. *See supra* notes 191–197, 205–207 and accompanying text.

314. Chiarella v. United States, 445 U.S. 222, 230 (1980).

315. *See* Government Memorandum in *Hunt*, *supra* note 176, at 14, 16 (citations omitted).

316. *See id.*

317. *Compare Chiarella*, 445 U.S. at 230 ("[Rule 10b-5] liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction."), *with* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977) (noting that the lower court's extension of breach of fiduciary duty into securities fraud was unwarranted).

318. *See* sources cited *supra* note 317.

319. *See supra* notes 280–281 and accompanying text.

320. United States v. Hunt, No. 05 CR. 395(DAB), 2006 WL 2613754, at *5 (S.D.N.Y. Sept. 6, 2006).

disclosure to their clients, which would have worked to take broker breaches of fiduciary duty—whatever those duties might be—out of Rule 10b-5. For it has been said that a broker owes no duty to a normal customer to *disclose* information about the movements of a stock, unless that broker is charged with managing that stock.[321] So perhaps the *Hunt* court was groping for the following argument: if brokers owe no disclosure duty to their clients,[322] and specialists owe the same duties as brokers,[323] then specialists, too, have no disclosure duty, and therefore cannot violate Rule 10b-5 through breach of fiduciary duty, since the only fiduciary duty whose violation is a fraud for Rule 10b-5 is that of the fiduciary duty to disclose.[324]

This argument is plausible, and it is the best argument that the *Hunt* court and the courts that cited *Hunt* could have used.[325] But this argument is incorrect for the simple reason that the disclosure duty that the *De Kwiatkowski* court had in mind was the fiduciary duty of reasonable care: to disclose to the client information about the stock that the client would not otherwise know.[326] There was no mention of a duty of loyalty, which is a duty to disclose potentially lucrative business opportunities.[327] Similarly, the other cases that discuss the duties of brokers pinpoint the scope of duty to the execution of the trade, but do not limit the duty of loyalty therein.[328] The duty of loyalty, on the other hand, *always* carries with it a duty to disclose.[329]

321. De Kwiatkowski v. Bear, Stearns & Co., Inc., 306 F.3d 1293, 1307–08 (2d Cir. 2002) (citing Caravan Mobile Home Sales, Inc. v. Lehman Bros. Kuhn Loeb, Inc., 769 F.2d 561, 567 (9th Cir. 1995); Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 953 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981); Robbinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 337 F. Supp. 107, 112 (N.D. Ala. 1971), *aff'd*, 453 F.2d 417 (5th Cir. 1972); Puckett v. Rufenacht, Bromagen & Hertz, Inc., 587 So. 2d 273, 280 (Miss. 1991)).

322. *See id.*

323. Mkt. St. Ltd. Partners v. Englander Capital Corp., No. 92 CIV. 7434 (LMM), 1993 WL 212817, at *9 (S.D.N.Y. June 14, 1993) (citing Note, *supra* note 121, at 697).

324. *Compare* Chiarella v. United States, 445 U.S. 222, 230 (1980) ("[Rule 10b-5] liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction."), *with* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977) (noting that the lower court's extension of breach of fiduciary duty into securities fraud was unwarranted).

325. *See, e.g.*, *Finnerty II*, 474 F. Supp. 2d 530, 533–34 & n.10 (S.D.N.Y. 2007) (citing *Hunt*, 2006 WL 2613754, at *6).

326. *See De Kwiatkowski*, 306 F.3d at 1307–08.

327. *See supra* notes 137–141 and accompanying text.

328. *See, e.g.*, Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 536 (2d Cir. 1999) (noting the limited scope of fiduciary duty while reconciling New York state cases on the topic).

329. *See supra* note 137–143 and accompanying text.

Like any broker must, every specialist must do everything possible so that her customer gets the best possible execution of an order.[330] This entails disclosing to the customer the identity of the principal,[331] all the information that is relevant for the principal to make an informed decision about that order, which includes the opportunity[332] that the specialist would take to interpose herself between both customers, and take away from them the potential benefit of their bargain.[333]

Insider trading and trading ahead are both violations of the duty of loyalty by agents because those agents use the informational property of their principals, without the principals' knowledge, to profit themselves.[334] That interpositioning is similar to a violation of the duty of loyalty is clear from the analogous nature of interpositioning to both trading ahead and insider trading.[335] Therefore, interpositioning is a violation of the duty of loyalty (which is the duty of disclosure), like insider trading,[336] and the failure to disclose matures to a violation of Rule 10b-5 and Section 10(b).[337] As such, interpositioning must take its place amongst its close analogues as a violation of the duty of loyalty, and therefore, a form of fraud, which, in connection with a purchase or sale of a security, is a violation of Rule 10b-5.

330. *See supra* Part I.E.I.

331. *See supra* Part I.E.1.

332. *See supra* Part I.E.2.

333. *See supra* notes 43–47 and accompanying text.

334. *Compare* RESTATEMENT (THIRD) OF AGENCY §§ 8.05 & cmt. c, 8.06(1)(a)(2) (noting that "it is a breach of an agent's duty to use confidential information of the principal for the purpose of effecting trades in securities although the agent does not reveal the information in the course of trading" and that to avoid a breach of fiduciary duty an agent must obtain the principal's consent forth use of the principal's information and "disclose[] all material facts that the agent knows, has reason to know, or should know would reasonably affect the principal's judgment unless the principal has manifested that such facts are already known by the principal or that the principal does not wish to know them"), *with* United States v. O'Hagan, 521 U.S. 642, 652 (1997) (noting that it is a "fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities" that is fraud), *and* United States v. Dial, 757 F.2d 163, 168 (7th Cir. 1985) ("[F]raud [is] to fail to 'level' with one to whom one owes fiduciary duties.").

335. *See supra* Part III.C.

336. *See, e.g.*, *O'Hagan*, 521 U.S. at 652.

337. Chiarella v. United States, 445 U.S. 222, 230 (1980). Perhaps it is time that the Court updated *Chiarella* to hold explicitly, rather than implicitly, that a violation of a duty of loyalty, in connection with a sale or purchase of a security, is always a fraud in violation of Rule 10b-5 because all duties of loyalty carry with them duties of disclosure. *See supra* notes 329–337 and accompanying text.

CONCLUSION

Interpositioning is a somewhat complicated procedure, and when combined with a poorly-researched—or perhaps not meticulously-researched—set of arguments, it is quite possible that the wrong legal result may occur: a court might incorrectly decide that specialists are not fiduciaries, do not owe a fiduciary duty, and therefore cannot deceive without making an affirmative representation that is contrary to fact, and thus a court would then find no fraud in the actions of a specialist who interpositions.[338] But specialists are fiduciaries, despite the fact that they each serve two principals,[339] and indeed they would remain fiduciaries even if they were not paid for their troubles—which they are.[340] And because specialists are fiduciaries, their quiet reaping of profits by interpositioning *does* amount to deception.[341] Because interpositioning is the extraction of economic rent, rather than something socially useful, such as true arbitrage, it is the sort of problem that Rule 10b-5 exists to combat.[342] Because specialists fit snugly into the shoes of agents,[343] while their interpositioning fits snugly into the rubrics of breach of the fiduciary duty of loyalty,[344] it appears that the courts that were given the task of judging the specialist prosecution cases came out with the wrong results.[345] Perhaps, as one commentator has suggested, courts might simply not be well designed to sit in judgment over complex financial matters, within complex financial regulatory systems.[346] On the other hand, if the present class action[347] does not settle before it gets to the merits, there is some hope of the courts setting the law straight and ruling that specialists who interpose violate their fiduciary duties of loyalty and thereby commit fraud, punishable by Rule 10b-5 and Section 10(b).

It may be that the interpositioning criminal cases are decided and that the civil case will settle before any court has a chance to correct its views, but what this analysis of the interpositioning prosecutions

338. *See supra* notes 266–269 and accompanying text.
339. *See supra* notes 285–289 and accompanying text.
340. *See supra* notes 271–273 and accompanying text.
341. *See supra* notes 75–79 and accompanying text.
342. *See supra* Part III.A.
343. *See supra* Part III.B.
344. *See supra* Part III.C.
345. *See supra* Parts III.B, III.D.
346. Bove, *supra* note 44, at 1386.
347. *In re* NYSE Specialists Sec. Litig., 260 F.R.D. 55 (S.D.N.Y. 2009).

has shown is that the various forms of fraud in finance all share a common theme, be it interpositioning, insider trading, or trading ahead: using the trust that a principal (a customer or a large commercial enterprise) might give a professional (the specialist, or the trader), the professional receives a benefit that is really just the exploitation of an opportunity that should have been reserved for the principal.[348] Surely, this is a cancer upon the financial system, about which the legal system must remain ever-vigilant.

348. *See supra* Part III.D.