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## Rule 10b-5: Scope of Liability Extended as Former Outsiders Become Market Insiders: *United States v. Chiarella*, 588 F.2d 1358 (2d Cir. 1978), cert. granted, 47 U.S.L.W. (U.S. May 15, 1979) (No. 78-1202)

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## Rule 10b-5: Scope of Liability Extended as Former Outsiders Become Market Insiders

*United States v. Chiarella*, 588 F.2d 1358 (2d Cir. 1978),  
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78-1202).

[W]e are well aware that the laws governing the securities market become more intricate and finely spun daily. Some engaged in the business of securities trading believe themselves to be characters from Victorian novels wandering aimlessly on treacherous moors.<sup>1</sup>

### I. INTRODUCTION

Rule 10b-5,<sup>2</sup> promulgated pursuant to Section 10(b)<sup>3</sup> of the Se-

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1. *H. Kook & Co. v. Scheinman, Hochstin & Trotta, Inc.*, 414 F.2d 93, 98 (2d Cir. 1969).

2. Rule 10b-5 provides as follows:

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

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

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

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1978) [hereinafter cited as rule 10b-5].

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

....  
(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j (1976).

curities Exchange Act of 1934,<sup>4</sup> is perhaps the most formidable weapon<sup>5</sup> available for use against those who would seek a fraudulent or unfair advantage in securities transactions. A cursory review of the salient features of the rule reveals the very nature of its power. The basis of its strength emanates from the broad and amorphous language found in the rule itself.<sup>6</sup> By implication, therefore, the scope of the rule remains unstated and undefined. Several omissions are quite obvious. For instance, the rule does not address or identify the elements needed to establish a breach of 10b-5.<sup>7</sup> Nor does it adequately delineate the size or composition of the plaintiff and defendant class<sup>8</sup> should a violation be shown. Rather the rule simply expounds the unlawful nature of deceptive, deceitful and manipulative practices in the purchase or sale of any security.<sup>9</sup> Hence, it is free from the restraints of any limiting language and thus retains a degree of flexibility.<sup>10</sup>

Since there are no clear indicia of congressional intent,<sup>11</sup> the task of defining and establishing the parameters of the rule has been left largely to the Securities and Exchange Commission (SEC) and the judicial branch.<sup>12</sup> The challenge has not gone unanswered; witness the recent Second Circuit pronouncement in

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4. *Id.* §§ 78a-78hh.

5. One commentator has observed: "If Rule X-10b-5 stood alone as a source of private civil remedies, its terms would be broad enough to blanket almost all malpractices in securities transactions." Comment, *The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120, 1130 (1950).

6. *See, e.g.*, Wright v. Heizer Corp., 411 F. Supp. 23, 35 (N.D. Ill. 1975) ("genius of 10b-5 lies in its breadth").

7. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 749 (1975).

8. *See generally* § III of text *infra*.

9. *See* note 2 *supra*.

10. *See, e.g.*, Conference on Codification of the Federal Securities Laws, 22 BUS. LAW. 793, 922 (1967) (comments of Milton Freeman reveal the SEC's failure to fully appreciate the rule's future impact).

11. Of nearly a thousand pages of hearings in the House, the combined references to § 10(b) (then § 9(c)) would scarcely fill a page. Much the same is true in the Senate.

The several committee Reports merely paraphrase the language of the several Bills and add little or nothing to the evidence on intent.

1 A. BROMBERG, SECURITIES LAW: FRAUD § 2.2(331), at 22.2-3 (1977). *See* S. REP. NO. 792, 73d Cong., 2d Sess. 18 (1934); H.R. REP. NO. 1838, 73d Cong., 2d Sess. 32 (1934).

12. The commentators as well have proffered their own thoughts. *See generally* H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW §§ 9.01 to .23 (rev. ed. 1978); 1 A. BROMBERG, *supra* note 11; A. JACOBS, THE IMPACT OF RULE 10b-5 (rev. ed. 1978); L. LOSS, SECURITIES REGULATION ch. 9 (2d ed. Supp. 1969).

*United States v. Chiarella*.<sup>13</sup> Faced with the duty of determining the permissible scope of defendants in a suit brought under section 10(b) for non-disclosure,<sup>14</sup> the court gave an expansive reading to rule 10b-5.<sup>15</sup> A new concept was created regarding insider trading liability.<sup>16</sup> Whereas previous decisions and SEC rulings under rule 10b-5 had limited liability for the non-disclosure of material information in the trading of securities to the corporate insider,<sup>17</sup> the tippee<sup>18</sup> of an insider, or one standing in a special relationship<sup>19</sup> with the injured party, the court in *Chiarella* went further. More specifically, liability was extended to reach the *mar-*

13. 588 F.2d 1358 (2d Cir. 1978), *cert granted*, 47 U.S.L.W. (U.S. May 15, 1979) (No. 78-1202).

14. See note 2 *supra*. Clause (b) of rule 10b-5 prohibits both misrepresentations and partial truths, but it may not reach the problem presented in *Chiarella*, silence or non-disclosure. It is necessary to look to clauses (a) and (c) which proscribe complete silence when there is a duty to disclose. See, e.g., *Myzel v. Fields*, 386 F.2d 718, 733 & n.6 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *List v. Fashion Park, Inc.*, 340 F.2d 457, 461-62 (2d Cir. 1965), *cert. denied*, 382 U.S. 811 (1965); *SEC v. Crofters, Inc.*, 351 F. Supp. 236, 255 (S.D. Ohio 1972). See also 3 L. LOSS, *supra* note 12, at 1439.

15. Other issues were of course raised in the case but are outside the ambit of this note. See note 92 *infra*.

16. Insider trading is a term of art embracing the trading in securities by insiders possessing inside information. Such an activity is prohibited by rule 10b-5. The term "insider" is more fully discussed in § III of text *infra*. "Inside information" can be defined as non-public facts relating to the business of the issuer, its securities, operations and affairs. See generally 5 A. JACOBS, *supra* note 12, § 66.02 (b) (citing cases).

17. For a discussion as to who is an insider, see 3 L. LOSS, *supra* note 12, at 1450-54; W. PAINTER, *FEDERAL REGULATION OF INSIDER TRADING* 132-44 (1968); Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulfur Proceeding*, 51 VA. L. REV. 1271, 1280-84 (1965); Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 COLUM. L. REV. 1361, 1383-90 (1965).

18. The term "tippee" like "insider" is a term of art—tippees have a duty of disclosure. Generally, the difference between an insider and a tippee stems from the circumstances under which the inside information is received. A tippee either does not learn inside information in a business capacity or does not have a legitimate business reason for knowing the inside information. For commentary, see Barnett, *Neither a Tippor Nor a Tippee Be*, 8 HOUS. L. REV. 278 (1970); Bromberg, *Tippee Risks and Liabilities*, 1970-1971 CORP. PRAC. COMM. 411; Glickman, *"Tippee" Liability Under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934*, 20 KAN. L. REV. 47 (1971); Rapp & Loeb, *Tippee Liability and Rule 10b-5*, 1971 U. ILL. L.F. 55.

19. Special relationship liability, other than that of insiders or tippees, under rule 10b-5 has largely attached to those who occupy a position of trust and confidence in relation to their customers. See, e.g., *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970) (failure to disclose market-maker status violates rule 10b-5); Comment, *Affiliated Ute Citizens v. United States—The Supreme Court Speaks on Rule 10b-5*, 1973 UTAH L. REV. 119, 125 (liability of broker-dealers discussed).

*ket insider*—a person having regular access to material nonpublic market information.<sup>20</sup> Traditional notions regarding the need to establish or show a relationship (fiduciary or otherwise) between the buyer and seller have thus been supplanted. The *Chiarella* decision does not mandate that a relationship between the parties be shown before liability will attach. The change in emphasis is readily apparent. Prior concerns over corporate insiders (and their privies) trading on undisclosed inside information have been broadened so as to become concerns over market insiders trading on undisclosed market information. The market insider would, like the corporate insider, be prohibited from using undisclosed market information for trading purposes and thus fall under the “disclose or abstain” rule articulated in the landmark decision of *SEC v. Texas Gulf Sulfur Co.*<sup>21</sup>

It is the purpose of this note to examine the *Chiarella* decision with regard not only to its relation to the past, but also as to its implications for the future. Historically, it is useful to inquire whether the market insider concept is indeed the next logical step in the judicial evolution of rule 10b-5. Similarly, the question must be posited whether the decision provides a workable standard for imputing future liability.

## II. FACTS OF THE CASE

The defendant Vincent Chiarella was employed as a “mark-up man” in the composing room of Pandick Press, a Manhattan firm engaged in the printing of various financial papers and documents.<sup>22</sup> When copy from a customer arrived at the shop, Chiarella would select type fonts and page layouts and then pass the manuscript on to be set into type. The documents handled in this manner ranged from the more mundane papers such as annual reports and proxy statements to the high drama paperwork surrounding tender offers and takeover bids.

Between September 1975 and November of the following year, Chiarella handled the raw material for an impending merger and four tender offers.<sup>23</sup> The procedure involved in the printing of documents of this kind was secretive in nature to preserve confidentiality. In order to prevent an anticipatory rise in the market price of

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20. “Market information” is outside information, *see* note 16 *supra*, or that information that affects the price of a company’s securities without affecting the firm’s earning power or assets. *See also* Fleischer, Mundheim & Murphy, *An Initial Inquiry Into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 799 (1973).

21. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). *See* text accompanying note 77 *infra*.

22. 588 F.2d at 1363.

23. *Id.*

the target company's stock should news of the tender offer become public, the type was set with certain information absent or in code.<sup>24</sup> Thus, when Emhart Corporation sought to gain control of USM Corporation, the documents delivered to Pandick Press read "Arabia Corp." and "USA Corp."<sup>25</sup> On the night before release the true names would be inserted during the final press run.

Chiarella was, however, "not merely an ordinary printer, but a knowledgeable stock trader."<sup>26</sup> In each of the five takeover bids which he handled, he was able to decipher the name of the target company from other available information—price histories, par values and the number of letters in the mock corporate names.<sup>27</sup> He would then call his broker and buy shares in the target corporation.<sup>28</sup> When the tender offer was publicly announced, the market price of Chiarella's stock increased and he would sell at a handsome profit. In the Emhart tender offer he made a profit of \$1,091.11; over the course of his dealings in the five takeover bids he netted more than \$30,000.<sup>29</sup>

In 1977 the SEC began an investigation into Chiarella's activities. In May of that year he agreed to a consent decree<sup>30</sup> to give up his profits to those who had sold him target stock. On January 4,

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24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.*

28.

Purchases

Target	Offeror	Shares	Date	Date Sold	Profit
USM	Emhart	300	9/5/75	9/9/75	\$ 1,019.11
Riviana Foods	Colgate-Palmolive	2300	2/5/76 to 2/10/76	2/26/76 to 3/16/76	8,948.55
Food Town Stores	Delhaize Freres	1100	10/11/76	10/21/76 to 12/1/76	2,990.30
Booth Newspapers	Times-Mirror	100	10/21/76	10/22/76	914.56
Sprague Electric	General Cable	3200	11/10/76	11/15/76	16,138.87
Total Profit:					\$30,011.39

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*Id.*

29. *Id.*

30. Other printers have felt the wrath of the SEC via consent decrees. *See, e.g.,* SEC v. Manderano, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,357 (D.N.J. 1978); SEC v. Primar Typographers, Inc., [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,734 (S.D.N.Y. 1976); SEC v. Ayoub, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,567 (S.D.N.Y. 1976); SEC v. Sorg Printing Co., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,034 (S.D.N.Y. 1975).

1978, he was indicted on seventeen counts<sup>31</sup> of willful misuse of material nonpublic information in connection with the purchase and sale of securities in violation of section 10(b) and rule 10b-5. After unsuccessfully moving to dismiss the indictment,<sup>32</sup> he was convicted by a jury on every count.<sup>33</sup>

### III. HISTORICAL BACKGROUND

Unfair or fraudulent transactions involving the trading of securities are not a modern day phenomena. Deceit in the marketplace has previously taken many forms. A common element to such activity, however, has usually been that one party has either misrepresented or omitted to disclose material facts to the other trading party. In cases involving the active misrepresentation of material facts the wrong is clearly identifiable since the injured party need only show that a misrepresentation took place. Cases involving non-disclosure or silence present difficulties.<sup>34</sup> Restated, the problem becomes one of identifying those situations in which a duty of

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31. The indictment was brought under the penalty provision of the 1934 Act, § 32(a), 15 U.S.C. § 78ff(a) (1976):

Any person who willfully violates any provision of this chapter, or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter, or any person who willfully and knowingly makes, or causes to be made, any statement in any application, report, or document required to be filed under this chapter or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 78o of this title, or by any self-regulatory organization in connection with an application for membership or participation therein or to become associated with a member thereof which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than \$10,000, or imprisoned not more than five years, or both, except that when such person is an exchange, a fine not exceeding \$500,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.

32. *United States v. Chiarella*, 450 F. Supp. 95 (S.D.N.Y. 1978).

33. Chiarella was sentenced to concurrent terms of one year on counts one through thirteen, to be suspended following one month's imprisonment. Imposition of sentence on the remaining counts was suspended and he was placed on probation for five years following his release from prison.

34. A close analogy exists between tort "misfeasance" and 10b-5 affirmative misrepresentation and between tort "nonfeasance" and 10b-5 nondisclosure: "Liability for 'misfeasance,' then, may extend to any person to whom harm may reasonably be anticipated as a result of the defendant's conduct, or perhaps even beyond; while for 'nonfeasance' it is necessary to find some definite relation between the parties, of such a character that social policy justifies the imposition of a duty to act."

Comment, *supra* note 19, at 122 n.24 (quoting W. PROSSER, *THE LAW OF TORTS* 339 (4th ed. 1971)).

disclosure is present. The process by which such a duty is established and the considerations underlying the imposition of such an obligation are of obvious concern to the participants in the securities marketplace. The *Chiarella* decision concerns the duty to disclose. To fully appreciate the implications of market insider liability it is necessary that the state of the law regarding liability for non-disclosure prior to *Chiarella* be presented. Particular emphasis will be placed upon the broadening scope of liability both at common law and under rule 10b-5.

### A. Scope of Liability For Non-disclosure Under the Common Law

The development of the common law in the area of fraudulent securities transactions was slow and uneven. Indeed, a defendant who either made an affirmative misrepresentation or failed to disclose a material fact when purchasing securities often escaped the imposition of liability altogether.<sup>35</sup> Yet, this is not to say that all plaintiffs were unsuccessful. The plaintiff who could allege the existence of a misrepresentation by the defendant was in a better position than one seeking to invoke liability because of silence or non-disclosure. The cause of action for misrepresentation at least was traceable to a progenitor in the common law—the action for deceit. The injured party had to establish that defendant made a false representation of a material fact with knowledge of its falsity and with the intent that plaintiff rely thereon.

On the other hand, one who could only allege the concealment of important facts (or non-disclosure) by the defendant<sup>36</sup> often had no cause of action. It was generally held that no remedy was available for damages resulting from the other party's silence unless a duty of disclosure existed.<sup>37</sup> Some jurisdictions never imposed a duty of disclosure. Others, however, did imply such a duty when certain corporate insiders, *e.g.*, directors, officers, and large shareholders, dealt in the shares of their own company. Yet, even in this regard there was a lack of uniformity as these jurisdictions espoused three separate and distinct views—majority, minority, and special facts—regarding the duty of disclosure and insider trading.<sup>38</sup>

35. See, *e.g.*, Note, *Civil Liability Under Rule X-10b-5*, 42 VA. L. REV. 537, 552-53 (1956) (discussing pre-10b-5 law); Comment, *supra* note 5, at 1125. By fulfilling these requirements and satisfying procedural requirements, the plaintiff could prevail. 5 A. JACOBS, *supra* note 12, § 2.01(a), at 1-8.

36. See note 35 *supra*.

37. Case Comment, *A New Concept of Fraud on the Securities Exchange—A Comment on In Re Cady* [,] Roberts & Co., 15 S.C. L. REV. 557, 563 (1963) (pre-10b-5 state of the law).

38. See, *e.g.*, Annot., 84 A.L.R. 615 (1933); Note, 53 L. Ed. 853 (1909).



The majority rule rejected the imposition of a duty of disclosure upon corporate insiders who dealt with their shareholders. While a fiduciary obligation was recognized between the corporation and the insider, the obligation did not extend to the individual shareholder.<sup>39</sup> It was reasoned that the insider owed no duty of disclosure because the shareholder could look at the company books and determine the value of the stock for himself.<sup>40</sup> Furthermore, it was believed that the shares possessed by a shareholder were indeed his personal property and the insider had no relationship to the property of the shareholder.<sup>41</sup> Therefore, under the majority rule a corporate insider could buy and sell the securities of his own corporation even though he had inside information regarding their value.<sup>42</sup>

Other jurisdictions followed the minority rule and imposed a duty to disclose upon insiders who traded upon inside information. It was reasoned that the insider should not benefit from his position within the corporation:

It might be that the director was in possession of information which his duty to the company required him to keep secret; and if so, he must not disclose the fact even to the shareholder; for his obligation to the company overrides that to an individual holder of the stock. But if the fact so known to the director cannot be published, it does not follow that he may use it to his own advantage, and to the disadvantage of one whom he also represents. The very fact that he cannot disclose prevents him from dealing with one who does not know, and to whom material information cannot be made known. If, however, the fact within the knowledge of the director is of a character calculated to affect the selling price, and can, without detriment to the interest of the company, be imparted to the shareholder, the director, before he buys, is bound to make a full disclosure.<sup>43</sup>

Under this view the insider was perceived as an agent or trustee of the shareholder.<sup>44</sup> Furthermore, it was often argued that it just was not morally proper for the insider to take advantage of the shareholder.<sup>45</sup>

A third common law interpretation regarding an insider's duty of disclosure can be found in the "special facts" doctrine first articulated in *Strong v. Repide*.<sup>46</sup> The case involved an insider who concealed information regarding an impending sale of company as-

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39. Note, *Purchaser's Duty to Disclose Under Securities and Exchange Commission Rule X-10B-5*, 40 MINN. L. REV. 62, 63 (1955) (disclosure at common law).

40. H. SPELLMAN, A TREATISE ON THE PRINCIPLES OF LAW GOVERNING CORPORATE DIRECTORS § 247, at 615 (1931).

41. Note, *supra* note 35, at 547-48.

42. See Case Comment, *supra* note 37, at 561.

43. *Oliver v. Oliver*, 118 Ga. 362, 368, 45 S.E. 232, 234 (1903).

44. See Note, *supra* note 35, at 550-51.

45. *Id.*

46. 213 U.S. 419 (1909).

sets from a seller of securities. The Supreme Court held that because of special facts the insider had a duty to disclose:

If it were conceded, for the purpose of the argument, that the ordinary relations between directors and shareholders in a business corporation are not of such a fiduciary nature as to make it the duty of a director to disclose to a shareholder the general knowledge which he may possess regarding the value of the shares of the company before he purchases any from a shareholder, yet there are cases where, by reason of the special facts, such duty exists.<sup>47</sup>

The essence of the rule flows from the fact that the buyer is possessed of superior knowledge or means of acquiring information.<sup>48</sup> The ultimate value of the "special facts" doctrine was, however, questionable. One writer has suggested that "[t]he 'special circumstances' rule neither supports nor repudiates the theory that a corporate insider has no fiduciary relation with shareholders from whom he purchases stock of his corporation and that to constitute fraud there must be actual misrepresentation."<sup>49</sup>

As a result of its restrictiveness, few successful suits were maintained under a common law action for non-disclosure. Those that were entertained applied principally to corporate insiders. Yet, this is not to say that efforts to reach beyond the insider under the common law have not been made. Indeed, the Second Circuit in *Schein v. Chasen*,<sup>50</sup> as one commentator has written, "breathed novel life into earlier state law cases."<sup>51</sup> In this case of first impression, it was held that a derivative suit on behalf of a corporation could be maintained against outsiders who traded on inside information.<sup>52</sup> Although later vacated,<sup>53</sup> the decision presents considerations parallel to those found in *Chiarella* and hence it is useful to consider the case and its subsequent history in detail.

*Schein* was a diversity suit brought by shareholders of the af-

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47. *Id.* at 431.

48. See 3 L. LOSS, *supra* note 12, at 1446-48. One writer has suggested that the ability to trade on such information is a necessary incentive to stimulate entrepreneurial activity. H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 138-41 (1966). But see Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425 (1967). Professor Manne has replied to his critics. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547 (1970).

49. See Case Comment, *supra* note 37, at 563.

50. 478 F.2d 817 (2d Cir. 1973), *vacated and remanded sub nom.* Lehman Bros. v. Schein, 416 U.S. 386 (1974). For detailed treatment of this case, see E. BRODSKY, *GUIDE TO SECURITIES LITIGATION* 121 (1974); Note, "*Tippee*" *Liability Extended to Remote Third Parties*, 53 NEB. L. REV. 279 (1974).

51. Kapp, *Trading on Undisclosed Material Information: Scope of Liability and Selective Disclosure*, in *FRAUD, INSIDE INFORMATION, AND FIDUCIARY DUTY UNDER RULE 10b-5*, 571, 575 (2d ed. 1976).

52. 478 F.2d at 823.

53. Lehman Bros. v. Schein, 416 U.S. 386 (1974).

affected corporation against several mutual funds which traded on inside information. The complaint alleged that since corporate information had been appropriated, a duty to the corporation had been breached in violation of Florida law. No securities laws were cited as a basis for the action.<sup>54</sup> The court, finding no Florida case on point, looked to *Diamond v. Oreamuno*,<sup>55</sup> a New York decision upholding the right of shareholders to sue derivatively on behalf of a corporation to recover profits from insiders who traded on inside information.<sup>56</sup> While it is obvious that *Diamond* involved insiders<sup>57</sup> trading on inside information and that *Schein* involved outsiders trading on inside information, the court reasoned that common elements were involved.<sup>58</sup> Third parties,<sup>59</sup> though not directors or officers of the injured corporation, who engaged in a common enterprise with insiders to misuse inside information were held in *Schein* to fall under the *Diamond* doctrine.<sup>60</sup>

Judge Kaufman,<sup>61</sup> in a strong dissent, rejected the notion that persons who are not insiders of a corporation may be found liable under some theory involving a breach of duty to the corporation:

In my view, it is no longer debatable that trading on inside information merits universal condemnation. The undesirable nature of "insider trading" is reflected in the prophylactic provisions of Section 16(b) of the Securities Exchange Act of 1934 and the more general antifraud principles of Section 10(b) of that Act. I fully agree with Judges Waterman and Smith that one with access to material inside information concerning a corporation's affairs who knowingly purchases or sells that corporation's shares before this information has become publicly available takes unfair advantage of unknowledgeable parties to the transaction. Indeed, the factual claims contained in the complaints before us have led to two federal actions—an SEC injunctive action and a private class action under rule 10b-5—now pending in the District Court for the Southern District of New York. But the adage that hard facts make bad law is about to come true here, despite Judge, later Justice, Cardozo's warning that judges are not free agents roaming at will to create law to fit the facts . . . In the absence of any viable precedent upon which to base the totally new concept of law espoused by my brothers, it is clear that they announce an ex-

54. A common law derivative action on behalf of the corporation was presumably brought because plaintiffs were not buyers during the "illegal trading period." See, e.g., *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), cert. denied, 343 U.S. 956 (1952); Whitaker, *The Birnbaum Doctrine: An Assessment*, 4 SEC. L. REV. 290, 293-94 (1972).

55. 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

56. *Id.* at 494, 498, 248 N.E.2d at 910, 912, 301 N.Y.S.2d at 78, 81.

57. See Case Comment, *supra* note 37, at 566.

58. 478 F.2d at 822.

59. Before *Schein* no common law decision had found remote "tippees" to be liable. See generally Rapp & Loeb, *supra* note 18.

60. 478 F.2d at 823.

61. A few years later, Judge Kaufman was to again face the issue of outsider liability for non-disclosure in *Chiarella*. The action, however, was brought not under the common law but under rule 10b-5.

traordinary, expansive, and incorrect reading of New York law solely because of their urge to "provid[e] a disincentive to insider trading." I agree with their objective but I question the means employed.

The court holds today that a person with *no relationship whatsoever*—fiduciary or otherwise—to a corporation, who trades its shares on the basis of material inside information becomes, *ipso facto*, a fiduciary of the corporation whose shares he traded . . . .<sup>62</sup>

The Supreme Court vacated and remanded *Schein* with instructions to refer to the Florida courts to determine Florida law.<sup>63</sup> As a result the corporation was held unable to recover in the absence of a showing of actual damage.<sup>64</sup> The Florida Supreme Court approvingly quoted Judge Kaufman's dissenting opinion in stating its belief that a duty of disclosure did not extend beyond the traditional insider of the corporation.<sup>65</sup> The effort to reach the outsider had failed.

Hence, under the common law<sup>66</sup> there was generally no recognized cause of action for silence or the non-disclosure of material inside information. Excepted from this general rule, however, were situations in which a fiduciary relationship could be established. A duty of disclosure then arose. The extent of that fiduciary obligation, when and if it could be shown, was nevertheless very limited. The liability of the corporate insider, for example, did not extend to the non-shareholder nor did it reach transactions on a stock exchange.<sup>67</sup> Even more notable was the limitation that such a duty of disclosure only attached to corporate insiders: directors, officers and major shareholders. The insider's relationship to the corporation served as the basis for imputing or triggering that fiduciary duty.

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62. 478 F.2d 817, 825 (2d Cir. 1973) (Kaufman, J., dissenting) (emphasis added) (citing B. CARDOZO, *THE NATURE OF THE JUDICIAL PROCESS* 141 (1921)).

63. *Lehman Bros. v. Schein*, 416 U.S. 386 (1974).

64. *Schein v. Chasen*, 313 So. 2d 739 (Fla. 1975), *aff'd*, 519 F.2d 453 (2d Cir. 1975).

65. *Id.* at 743-46.

66. In the past few years a number of states have passed statutes dealing with the problem of insider trading. See, e.g., CAL. CORP. CODE § 25402 (West 1977):

It is unlawful for an issuer or any person who is an officer, director or controlling person of an issuer or any other person whose relationship to the issuer gives him access, directly or indirectly, to material information about the issuer not generally available to the public, to purchase or sell any security of the issuer in this state at a time when he knows material information about the issuer gained from such relationship which would significantly affect the market price of that security and which is not generally available to the public, and which he knows is not intended to be so available, unless he has reason to believe that the person selling to or buying from him is also in possession of the information.

67. *Perry v. Pearson*, 135 Ill. 218, 25 N.E. 636 (1890). See Case Comment, *supra* note 37, at 564.

## B. Scope of Liability For Non-disclosure Under Rule 10b-5

Whereas attempts to expand liability beyond the traditional insider have generally proved fruitless under the common law, such efforts have enjoyed a modicum of success under rule 10b-5. The lack of any clear congressional direction<sup>68</sup> has left the courts free to pursue the broad policy objective of section 10(b)—the prevention of fraud.<sup>69</sup> A trend toward broader liability has emerged as frontier areas of liability are identified and subsequently covered by the rule. The state of the law after the enactment of the federal securities laws was for most purposes similar to the scope of liability recognized at common law.<sup>70</sup> Despite the fact that rule 10b-5 prohibits “any person”<sup>71</sup> from engaging in prohibited activities, the rule was initially applied only to those persons defined under Section 16 of the Securities Exchange Act of 1934.<sup>72</sup>

In *Cady, Roberts & Co.*,<sup>73</sup> however, the SEC signalled that the scope of liability under rule 10b-5 extended beyond the traditional insider. The question in that case was whether a broker-dealer had violated rule 10b-5 by trading after it acquired inside information conveyed by a representative of the brokerage firm who also served as a director of the corporation. The SEC held:

[Officers, directors, and controlling shareholders] do not exhaust the classes of persons upon whom there is such an obligation [to disclose]. Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. Thus our task here is to identify those persons who are in special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited.<sup>74</sup>

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68. See note 11 & accompanying text *supra*.

69. Some have claimed that the term fraud as used in the Act was not limited to common law concepts but was designed to include “all deceitful practices contrary to the plain rules of common honesty.” Loss, *The SEC and the Broker-Dealer*, 1 VAND. L. REV. 516, 517 (1948) (citing *People v. Federated Radio Corp.*, 244 N.Y. 33, 38, 154 N.E. 655, 657-58 (1926)).

70. See generally *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951); *Ward La France Truck Corp.*, 13 S.E.C. 373 (1943); Case Comment, *supra* note 37, at 565.

71. See note 2 *supra*.

72. Section 16 defines corporate insiders as officers, directors and “[e]very person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security . . .” 15 U.S.C. § 78p(a) (1976).

73. 40 S.E.C. 907 (1961).

74. *Id.* at 912 (footnotes omitted).

The test gleaned from this opinion concerned the circumstances under which a person obtained inside information. The emphasis was on a relationship with the corporation giving "access" to the inside information.<sup>75</sup>

The next major watershed in the evolution of rule 10b-5 liability for non-disclosure occurred in *SEC v. Texas Gulf Sulfur Co.*<sup>76</sup> Officers and employees of the company made purchases of company stock after learning about the great potential for an extraordinary ore discovery. The SEC alleged that the insiders as well as their tippees had violated rule 10b-5. The court, after re-stating the *Cady, Roberts* access test, declared:

Insiders, as directors or management officers are, of course, by this Rule, precluded from so unfairly dealing, but the Rule is also applicable to one possessing the information who may not be strictly termed an "insider" within the meaning of Sec. 16(b) of the [Exchange] Act . . . . Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed. So, it is here no justification for insider activity that disclosure was forbidden by the legitimate corporate objective of acquiring options to purchase the land surrounding the exploration site; if the information was, as the SEC contends, material, its possessors should have kept out of the market until disclosure was accomplished.<sup>77</sup>

The court of appeals in this decision seemed to adopt a "possession" test in addition to the "access" test.<sup>78</sup> This holding has been the source of some confusion among the commentators who have suggested a variety of interpretations regarding the interaction of the access test and possession test;<sup>79</sup> whether it served to merely augment the access test or to modify it has been unclear. Cases before<sup>80</sup> and after<sup>81</sup> *Texas Gulf Sulfur* do not seem to offer any definitive synthesis of the two tests.<sup>82</sup> In either event it is clear that

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75. *Id.*

76. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

77. *Id.* at 848 (footnote omitted; citations omitted).

78. 5 A. JACOBS, *supra* note 12, at 3-273.

79. *Id.* at 3-275 n.19 (citing among others: Ruder, *Texas Gulf Sulfur—The Second Round: Privy and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 NW. U.L. REV. 423, 438-40 & n.88 (1968); Sandler & Conwill, *Texas Gulf Sulfur: Reform in the Securities Marketplace*, 30 OHIO ST. L.J. 225, 238-42 (1969); Note, *How Big a House of Cards? Private Actions and Insiders Under Rule 10b-5*, 6 SAN DIEGO L. REV. 243, 263 (1969); Case Comment, *supra* note 37, at 559, 572 (1963)).

80. See 5 A. JACOBS, *supra* note 12, at 3-275 & n.20 (citing cases).

81. *Id.* at 3-275 & n.21 (citing cases).

82. One commentator has offered the following as a rationalization of the two tests:

The best analysis would require that an insider or a tippee must have both possession of inside information and direct or indirect access. No restrictions with respect to trading and recommending are im-

those held liable in *Texas Gulf Sulfur*, if not traditional insiders, had at a minimum obtained inside information because of an employment relationship with the corporation. Hence, the need to show a nexus between the insider and the corporation under either the possession or access test continued as a vital element.

Even this nexus requirement, however, came under attack in a case decided shortly after *Texas Gulf Sulfur*. In *SEC v. Great American Industries, Inc.*,<sup>83</sup> several judges of the Second Circuit expressed a willingness to extend the duty of disclosure beyond previously recognized notions of fiduciary obligations. The case concerned several persons who sold mining properties to Great American in exchange for its shares. The sellers did not disclose the fact that a substantial part of the price would be allocated to finders. The majority of the Second Circuit held that the facts went beyond mere non-disclosure and did not find it necessary to determine whether there should be a duty of disclosure:

It must be conceded that imposing on sellers of property or finders a duty of full disclosure to a buyer issuing securities in exchange, with a consequent duty on the part of the latter to publicize material facts so disclosed, would increase the protection afforded investors and traders by the securities laws. On the other hand, to read Rule 10b-5 as placing an affirmative duty of disclosure on persons who in contrast to "insiders" or broker-dealers did not occupy a special relationship to a seller or buyer of securities, would be occupying new ground and would require most careful consideration.<sup>84</sup>

Judge Kaufman, in concurrence, expressed a willingness to occupy this new ground:

Those who buy or sell securities may no longer assume that the unmended fences of common law fraud will remain the outer limits of liability under Rule 10b-5. . . .

....

In sum, any claim that material facts were withheld in a transaction in connection with the sale or purchase of securities must be scrutinized with care, whether or not there would have been liability at common law for such a deed.<sup>85</sup>

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posed on an insider or a tippee unless he has actual or perhaps constructive knowledge—i.e., possession—of inside information. Clearly, an insider or tippee needs actual knowledge of inside information before he can tip it. Therefore, possession of inside information is a prerequisite for imposing limits on insiders or tippees, and hence, in any meaningful sense possession is also needed before someone can be an insider or a tippee. Access is equally needed. An insider has access because he obtains his information in his business capacity. A tippee must get inside information about the issuer from an insider or from a tippee who acquired it from an insider, so the tippee also has access, albeit indirectly.

*Id.* at 3-277 to -278 (footnotes omitted; emphasis in original).

83. 407 F.2d 453 (2d Cir. 1968), *cert. denied*, 395 U.S. 920 (1969).

84. *Id.* at 460.

85. *Id.* at 462-63 (Kaufman, J., concurring).

Finally, in order to complete this historical introduction, it is necessary to consider *Investors Management Co.*,<sup>86</sup> a case in which an aircraft manufacturer disclosed information regarding its earnings to a broker-dealer who disseminated the information throughout the various departments of the firm. Members of the individual departments in turn passed the information to several institutional clients. Large amounts of stock were sold before the revised earnings estimate became public. The SEC determined that the prohibitions of rule 10b-5 applied to even the very remote tippee:

We consider that one who obtains possession of material, non-public corporate information, which he has reason to know emanates from a corporate source, and which by itself places him in a position superior to other investors, thereby acquires a relationship with respect to that information within the purview and restraints of the antifraud provisions.<sup>87</sup>

In a concurring opinion Commissioner Smith sought to emphasize the need for some relationship to the corporation in that the prohibitions of rule 10b-5 should apply principally to corporate insiders and their privies.<sup>88</sup>

In summation, it can be seen that rule 10b-5 has undergone an evolutionary transformation. The scope of liability for non-disclosure has broadened beyond that recognized at common law as the concept of the traditional insider has been altered by the "access" test<sup>89</sup> of *Cady, Roberts* and the "possession" test<sup>90</sup> of *Texas Gulf Sulfur*. Yet a quick perusal of these and other decisions<sup>91</sup> reveals the presence of several constants. In the area of non-disclosure, rule 10b-5 has only been applied to those persons having some relationship to the corporation whose securities were traded. Indeed the inside information itself may provide the basis for that relationship. Restated, it would appear that for rule 10b-5 to apply, the "minimum" nexus necessary would be that the undisclosed information originate or emanate from the affected corporation.

#### IV. THE COURT'S DECISION

On appeal, Chiarella admitted to the activities outlined in the

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86. 44 S.E.C. 633 (1971). See also Comment, *Investors Management Company and Rule 10b-5—The Tippee at Bay*, 72 COLUM. L. REV. 545 (1972); Comment, *Investors Management: Institutional Investors As Tippees*, 119 U. PA. L. REV. 502 (1971).

87. 44 S.E.C. at 644.

88. *Id.* at 648. See text accompanying note 120 *infra*.

89. See note 74 & accompanying text *supra*.

90. See note 77 & accompanying text *supra*.

91. See, e.g., *Shapiro v. Merrill, Lynch Pierce, Fenner, & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974); *SEC v. Lum's, Inc.*, 365 F. Supp. 1046 (S.D.N.Y. 1973); *Investors Management Co.*, 44 S.E.C. 633 (1971).



government's indictment but challenged his conviction on the ground<sup>92</sup> that he was outside the reach of section 10(b) of the Securities Exchange Act of 1934 as well as rule 10b-5. Citing the holding in *Texas Gulf Sulfur*,<sup>93</sup> he reasoned that since he was not an insider of the target corporations he owed no fiduciary duty to the target shareholders who sold their stock. Hence, he claimed he was not subject to the "disclose or abstain" rule of *Texas Gulf Sulfur* and had not violated rule 10b-5.

The Court of Appeals for the Second Circuit rejected his arguments and affirmed the jury verdict. The basis for that decision, as articulated by Chief Judge Kaufman, was founded upon the court's perception of the congressional policy underlying the enactment of the federal securities laws. Quite simply it was argued that such measures were passed to "protect the integrity of the marketplace in which securities are traded."<sup>94</sup> The court claimed that the philosophy of *caveat emptor* was not a proper standard; it had been supplanted by a system requiring equal access to information necessary for reasoned investment decisions.<sup>95</sup> Chiarella had violated basic principles of fairness and had impugned the integrity of the securities marketplace.

More specifically, the court claimed that the defendant had construed the principles underlying *Texas Gulf Sulfur* too narrowly.<sup>96</sup> While it was true that he has not an insider of the target corporations, that fact was deemed irrelevant.<sup>97</sup> He had gained an unfair advantage and had reaped as much benefit as any insider. Referring to the congressional purpose in enacting the securities laws, the court declared that "[a]nyone—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose. And if he cannot disclose, he must abstain

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92. Other issues were also raised on appeal. Chiarella contended to no avail that the fair notice element of the due process clause would be violated if rule 10b-5 were given such an expansive reading in a criminal case. The dissent expressed similar fears: "Today's decision expands § 10(b) drastically, . . . and alarmingly, it does so in the context of a criminal case." 588 F.2d at 1373 (Meskill, J., dissenting). See also 3 A. BROMBERG, *supra* note 11, § 10.3, at 241 (criminal aspects of rule 10b-5).

An issue also arose concerning the nature of the intent required to establish a criminal violation of rule 10b-5. The court held that the government need only show that the defendant engaged in "knowingly wrongful" conduct and was not required to prove a specific intent to defraud. 588 F.2d at 1371.

93. See text accompanying note 77 *supra*.

94. 588 F.2d at 1365 (quoting *United States v. Brown*, 555 F.2d 336, 339 (2d Cir. 1977)).

95. 588 F.2d at 1362.

96. *Id.* at 1365.

97. *Id.* at 1364.

from buying or selling."<sup>98</sup>

The scope of liability under rule 10b-5 was thus expanded to include the market insider—one who has regular access to market information. The court likened this new concept to the category of "quasi-insider" mentioned by the American Law Institute (ALI) in its proposed Federal Securities Code.<sup>99</sup> Furthermore, the majority claimed support from the fact that the ALI had proposed that its version of rule 10b-5<sup>100</sup> could in most cases be used to reach particularly egregious fraudulent transactions not falling under the language of its insider section.<sup>101</sup> The court characterized Chiarella's conduct as sufficiently egregious to fit even the most restrictive definition of a quasi-insider.

The court garnered further justification for affirming Chiarella's conviction from *Affiliated Ute Citizens v. United States*.<sup>102</sup> This was a civil action involving the First Security Bank of Utah which acted as transfer agent for shares of the Ute Development Corporation, which was created by the federal government to hold assets for a group of mixed-blood Ute Indians. Two employees of the bank sought to buy stock in the corporation from its Indian shareholders at a low price and re-sell the shares at a profit to a market consisting of whites. The Supreme Court held that such activities violated rule 10b-5 and gave rise to a duty of disclosure.<sup>103</sup> The Second Circuit considered the case significant because it seemingly equated regular access to market information with a duty of disclosure.

The court then addressed the issue whether Chiarella could relieve himself of his market insider's duty of disclosure by claiming the protection of the tender offeror who was the source of his information. Because a tender offeror may purchase up to five percent of the stock of its prospective target without any requirement of disclosure,<sup>104</sup> the defendant sought to clothe himself with a similar

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98. *Id.* at 1365.

99. ALI, FEDERAL SECURITIES CODE (Proposed Official Draft, March 15, 1978) [hereinafter cited as FEDERAL SECURITIES CODE].

100. *Id.* § 1602.

(a) [General.] It is unlawful for any person to engage in a fraudulent act or to make a misrepresentation in connection with (1) a sale or purchase of a security, an offer to sell or buy a security, or an inducement not to buy or sell a security, (2) a proxy solicitation or other circularization of security holders in respect of a security of a registrant, (3) a tender offer or a recommendation to security holders in favor of or opposition to a tender offer, or (4) activity or proposed activity as an investment adviser.

101. *Id.* § 1603, Comment 3(d).

102. 406 U.S. 128 (1972). See Comment, *supra* note 19.

103. 406 U.S. at 152-53.

104. 15 U.S.C. §§ 78m(d), 78n(d) (1976).

exemption. The attempt proved unsuccessful as the court held that a tender offeror is not a market insider since it does not receive market information but in fact creates it. Furthermore, the majority reasoned that there was a substantial difference in assumed economic risk<sup>105</sup> between the tender offeror and someone in Chiarella's position. The tender offeror faced real economic unknowns while Chiarella suffered no economic risk. His liability was, therefore, not derivative.

In conclusion, the *Chiarella* court reiterated its belief that the imposition of a duty of disclosure upon the market insider was but a logical application and extension of the congressional policies underlying the rule of *Texas Gulf Sulfur*. "[T]he Rule is based in policy on the justifiable expectations of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."<sup>106</sup>

## V. ANALYSIS

Justice Rehnquist, writing for the majority in *Blue Chip Stamps v. Manor Drug Stores*,<sup>107</sup> critically observed that "[w]hen we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn."<sup>108</sup> The decision by the Second Circuit in *Chiarella* can be said to have caused another acorn to germinate. That the creation of the market insider concept drastically expands the scope of liability under rule 10b-5 cannot be denied since previously the rule had been applied only to corporate insiders, tippees of the insider or those standing in a special relationship to traders in the market.

It now remains to consider the validity and effect of that decision in light of the following inquiries: (1) whether the supportive authorities cited by the majority are of persuasive precedential value to sustain the creation of market insider liability and (2) the implications of the *Chiarella* decision.

### A. Authority for Market Insider Liability

"That appellant was not an insider of the companies whose se-

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105. The dissent, however, was not convinced that economic risk is at all determinative: "We have been cited no case holding that the degree of risk assumed by a trader in possession of nonpublic information is determinative of the trader's liability for nondisclosure or renders his conduct fraudulent." 588 F.2d at 1375 (Meskill, J., dissenting).

106. 588 F.2d at 1365 (quoting *SEC v. Texas Gulf Sulfur*, 401 F.2d 833, 848 (2d Cir. 1968)).

107. 421 U.S. 723 (1975).

108. *Id.* at 737.

curities he traded is true, but irrelevant."<sup>109</sup> In this one sentence the majority has succeeded in erasing many of the previously established limits on liability for non-disclosure under rule 10b-5. The fact that Chiarella was not an insider is not irrelevant if viewed from the proper perspective. For the basic elements underlying the notion of corporate insider liability provide or serve to establish the whole nature of *any* duty of disclosure under rule 10b-5.

Whereas prior decisions centered around the misuse of inside corporate information, the court in *Chiarella* talks of the misuse of "market" information.<sup>110</sup> The required element of a relationship to a corporation giving access to inside information has been transformed in *Chiarella* to the need to show an access to "market" information. The court claimed support from several sources including the congressional policies underlying the decision in *Texas Gulf Sulfur*, the Supreme Court decision in *Affiliated Ute Citizens*, and the ALI's codification efforts in the Federal Securities Code. It is only proper that an inquiry be undertaken to examine the authority cited by the majority for such a change.

The court claimed initial support from the intent manifested by Congress in enacting the anti-fraud provision of the securities laws.<sup>111</sup> Armed with the obligation to preserve the integrity of the marketplace, it is reasonable, argued the court, to include market insiders within the ambit of the anti-fraud provision. Indeed the court states at one point, "Congress did not limit itself to protecting shareholders from the speculations of their officers and directors."<sup>112</sup> While this statement may be true, it does not follow that the reach of 10b-5 is unlimited. If the rule were to be given such an expansive reading there would be little need for the other provisions of the securities laws; rule 10b-5 would be the sword by which unfairness and dishonesty would fall.

Furthermore, the statement is misleading and sets up a straw man for the Second Circuit to knock down. Rule 10b-5 does reach beyond officers and directors. As articulated earlier, prior case law established that rule 10b-5 does extend beyond the traditional common law notion of the insider. Yet this should not be construed to be a license to implement any notions of marketplace egalitarianism. A perusal of prior case law shows that, while the scope of liability has broadened, certain constants have remained. By deeming Chiarella's lack of insider status irrelevant the court ignored previous interpretations of congressional intent.

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109. 588 F.2d at 1364.

110. See note 20 *supra*.

111. 588 F.2d at 1365.

112. *Id.*

That intent is embodied in the efforts of the courts and the SEC to establish various tests to determine when a duty of disclosure arises. The "access" test of *Cady, Roberts* requiring the existence of a relationship to the corporation whose stock has been traded is the cornerstone of rule 10b-5 liability for non-disclosure. The requirement of a relationship giving access simply reflects notions of fiduciary obligations developed under common law and federal law.<sup>113</sup> The holding in *Texas Gulf Sulfur* reaffirmed this belief as the Second Circuit acknowledged in that decision that the *Cady, Roberts* analysis was the "essence" of rule 10b-5. Yet, the court in *Chiarella* chose to ignore this aspect of *Texas Gulf Sulfur* and simply claimed support from the congressional policies underlying that decision. Judge Meskill, in dissent in *Chiarella*,<sup>114</sup> ironically pointed out that the Second Circuit itself in *Radiation Dynamics, Inc. v. Goldmuntz*<sup>115</sup> remarked: "The essential purpose of Rule 10b-5, as we have stated time and time again, is to prevent corporate insiders and their tippees from taking unfair advantage of the uninformed outsider."<sup>116</sup> Under *Chiarella* the "essential purpose" of rule 10b-5 appears to have undergone a transformation.

Yet it must also be acknowledged that recent administrative proceedings and case law suggested a change of sorts. Some decisions have expanded the notion of a duty to the corporation to one of a duty to the marketplace.<sup>117</sup> However, these decisions have also re-emphasized a basic ingredient gleaned from *Cady, Roberts* and *Texas Gulf Sulfur*—the non-public information must originate with the corporation whose stock has been traded. In *Investors Management Co.*,<sup>118</sup> the SEC, while broadening the class of tippees subject to rule 10b-5, acknowledged as much:

We consider that one who obtains possession of material, non-public corporate information, which he has reason to know emanates from a corporate source, and which by itself places him in a position superior to other investors, thereby acquires a relationship with respect to that information within the purview and restraints of the antifraud provisions.<sup>119</sup>

Commissioner Smith in a special concurrence wrote that the emphasis of rule 10b-5 "should continue to be upon the conduct of corporate insiders and their privies, . . . rather than upon a concept—too vague for me to apply with any consistency—of relative

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113. See, e.g., 3 L. Loss, *supra* note 12, at 1445-53 (summarizes relationship between common law doctrines of fiduciary obligations and the law under rule 10b-5).

114. 588 F.2d at 1374 (Meskill, J., dissenting).

115. 464 F.2d 876 (2d Cir. 1972).

116. *Id.* at 890.

117. See cases cited in note 91 *supra*.

118. 44 S.E.C. 633 (1971).

119. *Id.* at 644.

informational advantage in the marketplace."<sup>120</sup>

The Second Circuit interpretation of congressional intent is therefore somewhat at odds with prior case law interpreting the same policies. Beginning with *Cady, Roberts* and continuing through *Texas Gulf Sulfur* and *Investors Management Co.* it is clear that while an expansion of the notion of duty has occurred there has been a continual need to show some kind of nexus with the affected corporation or injured party. Chiarella was not an insider nor did his information emanate from the corporation whose stock was traded. While the court admits this much, it neglects the broader implications of the nature of the insider's duty—the need to show a relationship which serves to trigger a fiduciary obligation.

The majority also found support for its holding from the Supreme Court decision in *Affiliated Ute Citizens v. United States*.<sup>121</sup> Two employees of a bank, which acted as a transfer agent for a corporation administering the assets of Ute Indians, bought stock from the Indian shareholders at a low price and re-sold the stock in a non-Indian market. The Court held that the defendants had a duty to disclose the fact that there was a price difference between the two markets as well as the defendants' market maker status.<sup>122</sup> The majority in *Chiarella* claimed that this imposition of duty resulted from the defendants' access to market information and as such was applicable to the factual situation before it.<sup>123</sup> Such a conclusion, however, is far from convincing.

In discussing the factors which led to the duty of disclosure in *Affiliated Ute Citizens*, the Court stated that there would have been no duty to inform the sellers that the stock was selling at a higher price in another market if the bank had acted merely as a transfer agent for the stock.<sup>124</sup> Rather the duty arose because of the fact that (1) the defendants "were active in encouraging a market for the UDC stock among non-Indians";<sup>125</sup> (2) "[t]he men, and hence the bank . . . were 'entirely familiar with the prevailing market for the shares at all material times'";<sup>126</sup> (3) "[t]he bank

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120. *Id.* at 648.

121. 406 U.S. 128 (1972).

122. *Id.* at 153.

123. *United States v. Chiarella*, 588 F.2d at 1368-69.

124. "We would agree that if the two men and the employer bank had functioned merely as a transfer agent, there would have been no duty of disclosure here." 406 U.S. at 151-52. The statement would suggest that absent something more, one in mere possession of market information would be under no duty of disclosure.

125. *Id.* at 152 (citing *Reynos v. United States*, 431 F.2d 1337, 1345 (10th Cir. 1970)).

126. 406 U.S. at 152 (citing *Reynos v. United States*, 431 F.2d at 1347)).

itself had acknowledged . . . that 'it would be [its] duty to see that these transfers were properly made' and that, with respect to the sale of shares, 'the bank would be acting for the individual shareholders.'<sup>127</sup> The result, therefore, seemed to be based on more than mere access to market information as the majority in *Chiarella* contends.

Thus the factors underlying the imposition of a duty upon corporate insiders applied equally to those in a special relationship to the trader. Again, the common element was the existence of a relationship between the parties involving "inherent trust and reliance by the plaintiffs."<sup>128</sup> The Second Circuit in *Chiarella* ignored the relationship requirement and chose merely to emphasize the access elements of the *Affiliated Ute* decision.

The *Chiarella* court also cited the ALI's Federal Securities Code<sup>129</sup> as a final basis upon which to rest the new liability imposed upon the market insider. More specifically, the court took solace in the fact that the ALI suggested the creation of a class of "quasi-insiders" which the majority called closely akin to the market insider. Yet as the dissent in *Chiarella* points out<sup>130</sup> it is equally clear that the ALI ultimately rejected this notion and chose to impose a duty of disclosure only upon insiders. Section 1603 of the proposed Code provides:

(a) [General.] It is unlawful for an insider to sell or buy a security of the issuer, if he knows a fact of special significance with respect to the issuer or the security that is not generally available, unless (1) the insider reasonably believes that the fact is generally available or (2), if the other party to the transaction (or his agent) is identified, (A) the insider reasonably believes that that person knows it, or (B) that person in fact knows it from the insider or otherwise.

(b) ["Insider."] "Insider" means (1) the issuer, (2) a director or officer of, or a person controlling, controlled by, or under common control with, the issuer, (3) a person whose relationship or former relationship to the issuer gives or gave him access to a fact of special significance about the issuer or the security that is not generally available, or (4) a person who learns such a fact from a person specified in section 1603(b) (including a person specified in section 1603 (b) (4)) with knowledge that the person from whom he learns the fact is such a person, unless the Commission or a court finds that it would be inequitable, on consideration of the circumstances and the purposes of this Code (including the deterrent effect of liability), to treat the person specified in section 1603 (b) (4) as if he were specified in section 1603 (b) (1), (2), or (3).<sup>131</sup>

It is interesting to note that the concept of relationship or of relationship giving access is retained by the ALI as a basic require-

127. 406 U.S. at 152.

128. See Comment, *supra* note 19, at 128.

129. See notes 99-101 & accompanying text *supra*.

130. 588 F.2d at 1374 (Meskill, J., dissenting).

131. FEDERAL SECURITIES CODE § 1603, at 528-29.

ment for imposing a duty of disclosure.<sup>132</sup>

The decision by the ALI to forego imposing a duty upon outsiders was based largely upon perceived difficulties of definition. Indeed, in Comment 3(d) to section 1603<sup>133</sup> the ALI specifically but respectfully rejected the position adopted by the three concurring judges in *SEC v. Great American Industries, Inc.*<sup>134</sup> to expand liability beyond previously recognized perceptions of fiduciary obligations. The ALI argued that "it is hard to find justification today for imposing a fiduciary's duty of affirmative disclosure on an outsider who is not a 'tippee.'" <sup>135</sup> Judge Kaufman, the author of the *Chiarella* decision, was one of the three concurring judges in *Great American Industries*.

In sum, it is clear that section 10(b) is activated not by mere elements of unfairness but by fraud. And it is black letter law that silence or non-disclosure, unlike misrepresentation, is fraud only when there is a duty to speak.<sup>136</sup> The courts have found such a duty when insiders and tippees or those in a special relationship with the injured party use information attained because of that relationship to trade in securities. Under the common law it was reasoned that liability arose only when a fiduciary, the corporate insider, breached his obligations. Under rule 10b-5 while there has been a broadening of the scope of liability it has been shown that there is still a need to show some nexus or relation between the parties. While *Chiarella's* conduct cannot be condoned, it can be forcefully argued that his actions simply fall outside rule 10b-5 as it now exists.

## B. Implications

The impact of the *Chiarella* decision upon rule 10b-5 may prove to be both far reaching and dramatic. The imposition of a duty of disclosure founded upon expanded notions of market fairness departs from prior legal thought. Whereas a duty of disclosure was previously imposed upon those who assumed a role or acquired a relationship with another based upon some fiduciary concept (thus a *limited* application of the fairness principle), the position expounded by the Second Circuit would require no such relationship. One who possesses knowledge of material facts unknown to the other party and which are not public will conceivably be under a duty of disclosure prior to any trading. No relationship between the parties need be shown.

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132. For a similar requirement of relationship at the state level, see note 66 *supra*.

133. FEDERAL SECURITIES CODE, at 538-39.

134. 407 F.2d 453 (2d Cir. 1968), *cert. denied*, 395 U.S. 920 (1969).

135. FEDERAL SECURITIES CODE, at 538.

136. See, e.g., W. PROSSER, *supra* note 34, § 106; 3 L. LOSS, *supra* note 12, ch. 9C.



Problems of scope and application are obviously inherent in the market insider principle. What is to be the standard by which future market participants may pattern their behavior to avoid liability? What liability, if any, attaches to tippees of market insiders? Will any informational advantage trigger a duty of disclosure? Is there any room under the concept by which a market insider may show that his informational advantage was a reward for economic savvy?<sup>137</sup> Are prior conceptions regarding a competitive market now supplanted by a broader concern with fairness and parity of information?

The decision offers little in the way of answers to these questions. No reasoned analysis was undertaken by the court to limit the scope of application. Indeed, the equal access principle may have effects beyond that envisioned by the court. An example will better illustrate the problem. While in the instant case *Chiarella* was not authorized by the tender offeror to use the information contained in the printing materials for his own advantage, what if the corporation had sold him that information? As an asset it is conceivable that corporate management had the right to sell it. The practice of "warehousing"<sup>138</sup> reflects this basic transaction. If the tender offeror, who is not a market insider under the *Chiarella* decision,<sup>139</sup> sells information regarding an impending transaction to several pension funds, who in turn purchase stock in the target corporation, do the prohibitions regarding the market insider apply?<sup>140</sup>

Such transactions have occurred and have been the subject of a study done by the SEC.<sup>141</sup> While it was concluded that purchases by the pension funds of stock of the tender offeror were violative of rule 10b-5 (as a traditional relationship existed giving access to the acquiring company), no mention was made of liability for purchases of stock in the target company. Indeed, it was concluded that warehousing should be dealt with under new rules rather than by applying rule 10b-5.<sup>142</sup> Herein lies a broader aspect

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137. See Fleischer, Mundheim & Murphy, *supra* note 20, at 816.

138. *Id.* at 811.

139. See note 105 *supra* (questioning economic risk criteria).

140. See Fleischer, Mundheim & Murphy, *supra* note 20, at 811.

141. SEC, INSTITUTIONAL INVESTOR STUDY REPORT, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. (1971) (cited in Fleischer, Mundheim & Murphy, *supra* note 20, at 811-12).

142. With respect, however, to passing on information about a prospective takeover effort to favored institutions, the persons who do so usually are the persons who plan the takeovers and ordinarily have no relationship to the target company, nor do they usually have any fiduciary duty to that company or its shareholders. This difference in relationships does not necessarily mean that such passing on of information concerning takeovers should be permitted, but it may well

of the problem. Can rule 10b-5 be legitimately expanded to reach the market insider, presupposing of course that that is a desired end, or is the problem better handled through other measures? Perhaps "we have reached a point where corporate officials, shareholders and potential investors, insiders and outsiders alike, are entitled to more explicit language in the statute, the only ultimate reflection of the democratic process of representative government."<sup>143</sup>

## VI. CONCLUSION

The decision reached by the Second Circuit in *Chiarella* represents the latest judicial effort to define the scope of liability under rule 10b-5. Unfortunately, the creation of a market insider duty of disclosure appears before us like some *a priori* principle without any clear indication that it is the next proper step in the evolution of rule 10b-5. Indeed, the "treacherous moors" upon which market participants tread have become more dangerous given the implications inherent in the parity of information notions of *Chiarella*.

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mean that if such activities are to be prohibited, this should be done by a rule specifically directed to that situation *rather than by an expanded interpretation of Rule 10b-5 resting on a somewhat different theory than that underlying that rule as to the obligations and duties of those who receive material undisclosed information.*

SEC, INSTITUTIONAL INVESTOR STUDY REPORT, H.R. DOC. NO. 92-64, 92d Cong., 1st Sess., summary vol. at xxxii (1971).

143. W. PAINTER, *supra* note 17, at 395 (footnote omitted).