
Patricia Stern

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INTRODUCTION

Rule 10b-5, promulgated under section 10(b) of the Securities Exchange Act of 1934, conditions an insider's right to trade in securities upon full disclosure of material nonpublic information. Classic application of 10b-5 is to transactions involving corporate executives and others who become aware of changes or decisions likely to influence the value of corporate shares in advance of other traders. The rule does not, however, operate cate-

1. Section 10(b) provides:
   It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
   (a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, 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.
   (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.

Rule 10b-5 was promulgated under section 10(b) and provides:
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   (a) To employ any device, scheme, or artifice to defraud,
   (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in 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.
3. At the minimum, insider trading is the buying and selling of corporate shares by officers, directors and stockholders who own more than 10% of the stock of a corporation listed on the national exchange. At issue in the Chiarella case was the propriety of expanding that definition to include other categories of persons with access to material, nonpublic information.
gorically against any singular class of persons. Read literally, it is applicable to "any" person.4

Perhaps because of its elastic language, 10b-5 has, since its inception in 1942, been liberally applied to a myriad of transactions characterized by the courts as "insider trades." Precedent established during the 1960's and early 1970's greatly broadened the concept of insider liability and increased the rule's potential as an antifraud device.6 Chiarella v. United States7 is recent indicia of the Supreme Court's attempt to reverse that trend.

On March 18, 1980, the Supreme Court reversed the conviction of Vincent Chiarella, an employee of a Wall Street printing firm who had been prosecuted under section 10(b) and rule 10b-5 of the Exchange Act. As a "markup man"8 for Pandick Press, Mr. Chiarella had access to confidential client files which outlined the details of prospective tender offers9 and mergers.10 Al-

5. See A. Bromberg, Securities Law: Fraud-Rule 10b-5 § 1.1, at 5 (1968). Frequent resort to the rule may be the result of its relatively loose jurisdictional requirements as well. Use of the telephone, clearly an instrumentality of interstate commerce, is enough to bring a transaction within the cognizance of the federal courts. Nationwide service of process and broad venue provisions are a further attraction.

6. In a series of administrative decisions and injunctive proceedings commencing in 1961, the SEC broadened the applicability of rule 10b-5 as a general prohibition against trading on nonpublic information in anonymous stock exchange transactions as well as in face-to-face dealings. Two of the most significant decisions were SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969) and In re Cady, Roberts & Co., 40 S.E.C. 907 (1961).


8. Financial printers, such as Pandick, service investment houses, banks, corporations, and other large institutions. They specialize in printing disclosure statements, newspaper announcements, proxies, merger proposals, tender offers and various other business documents. As a markup man, Chiarella received customer copies first, and it was his job to arrange the type and disseminate pages to copy cutters.

9. An offer to purchase shares made by one company directly to the stockholders of another company is a tender offer. The term "tender offer" is not defined in the Exchange Act, but it has been held not to encompass purchases in the open market, whether or not made for purpose of obtaining control. Water & Wall Assoc. v. American Consumer Indus., [1973] Fed. Sec. L. Rep. (CCH) ¶ 93,943 (D.N.J. 1973). A tender offer has been held to include "any public invitation to a corporation's shareholders to purchase
though some of the information was received in coded form, between September 1975 and November 1976, Chiarella managed to identify the parties to five impending takeovers.\textsuperscript{11} He invested in target securities before the tender offers were published and profited handsomely from the subsequent rise in the price of his stock once the bids were announced.\textsuperscript{12}

The Securities and Exchange Commission (SEC)\textsuperscript{13} challenged Chiarella's failure to disclose material,\textsuperscript{14} nonpublic information prior to using that information as an exclusive trading advantage on the stock market. However, Justice Powell, writing for the Supreme Court majority, ruled that mere nondisclosure of market information was not actionable fraud under rule 10b-5 absent a confidential or fiduciary relationship between Chiarella and the individuals who sold him target stock.\textsuperscript{15} The Court flatly rejected any notion that 10b-5 liability could be based solely upon a trader's informational advantage in an arm's length transaction.

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10. Corporations merge when one company acquires the assets, liabilities, franchises, and powers of another. Since mergers have provided an important vehicle to positions of market dominance, they are regulated and scrutinized under the provisions of section 7 of the Clayton Act. 15 U.S.C. § 18 (1976).

11. United States v. Chiarella, 588 F.2d 1358, 1363 (1978). The documents Chiarella received provided vital information, such as the market in which the shares were traded, the par value, the number of shares outstanding, and the highs and lows for the previous year. By comparing these figures with a stock guide book he received from his broker, Chiarella deduced the names of the subject corporations.

12. For a more detailed analysis of the way in which publication of a tender offer affects the value of target stock, see Fleischer & Mundheim, \textit{Corporate Acquisition by Tender Offer}, 115 U. Pa. L. Rev. 317 (1967).

13. The Securities and Exchange Commission (SEC) was created in 1934 as an independent, quasi-judicial agency of the United States government, to administer the Securities Act and the Exchange Act. In its capacity as a judicial body, the SEC is empowered to discipline brokers, dealers, and investment advisers registered with it. SEC decisions are not controlling on courts in civil actions but they are often persuasive. Pursuant to section 21(d) of the Exchange Act, the SEC can transmit evidence of a crime to the Attorney General. The existence of this referral power allows the SEC to bring suit in federal district court. \textit{JACOBS, supra} note 9, at § 5.


The rule of the Chiarella case, that silence does not amount to fraud unless there is an affirmative duty to speak, is fashioned after the common law of fraud and deceit. The imposition of a common law constraint upon application of 10b-5 is consonant with the conservatism which has characterized the Supreme Court's approach to 10b-5 and other antifraud provisions since 1975. In a series of decisions, beginning with Blue Chip Stamps v. Manor Drug Stores, the Supreme Court has consistently limited the scope of the rule.

Despite the latest departure from expansive use of rule 10b-5, the Chiarella decision should not be perceived as a judicially created loophole through which investors can get rich quick on confidential information. A perfunctory look at the six to three

16. Common law has greatly influenced the development of rule 10b-5 as an antifraud device. Particularly during the 1950's, courts invoked tort law to restrict 10b-5 liability. See generally, 2 L. Loss, SECURITIES REGULATION 1430-31 (2d ed. 1961) [hereinafter cited as Loss].

The common law elements of a claim for fraud and deceit have been described as false representation of a material fact made by the defendant with knowledge of its falsity (or some other element of scienter) and with the intention that the plaintiff rely thereon, resulting in justifiable reliance by and consequently damage to, the plaintiff. W. PROSSER, TORTS § 85, at 705-06 (1st ed. 1941); see also Note, The Liability of Directors and Officers for Misrepresentation in the Sale of Securities, 34 COLUM. L. REV. 1090 (1934).

If plaintiff's claim was based on mere nondisclosure, as opposed to express misrepresentation, proof of a fiduciary relationship between the parties, or proof that defendant knew plaintiff was acting under a mistaken belief as to a material fact was required. Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275, 283 (2d Cir. 1975). Thus, under the common law, a corporate insider could sell the stock of his own company with relative impunity because he owed no fiduciary duty to the buyer. In In re Cady, Roberts & Co., 40 S.E.C. 907, 913-14 (1961), the SEC interpreted rule 10b-5 as broader than the common law, imposing an affirmative duty to disclose inside information upon the purchaser of securities without regard to any fiduciary duty owed the buyer.

The reader should not assume, however, that rule 10b-5 has completely shed its inhibiting common law heritage. See, e.g., Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (no private action under 10b-5 unless scienter is alleged); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (under rule 10b-5, plaintiff must be the purchaser or seller of securities to have standing).

17. See, e.g., Aaron v. SEC, 446 U.S. 680 (1980) (the Hochfelder scienter requirement was extended to actions brought by the SEC); Santa Fe Indus. v. Green, 430 U.S. 462 (1977). The term "fraud" does not include overreaching by a controlling shareholder unless accompanied by actual deception, and no person can be held liable for damages under rule 10b-5 unless he can be shown to have acted with scienter.

The Court has also taken measures to limit private rights of action under the rule. In Piper v. Chris-Craft Indus., 430 U.S. 1 (1977), the unsuccessful contender for control of a target company brought action against the successful contender for alleged violations of securities laws. Chief Justice Burger ruled that tender offerors were not within the class of persons the securities laws were designed to protect. See also Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

decision does not reveal the discordant interpretations of rule 10b-5 espoused by members of the Court in two separate concurring and two dissenting opinions. The majority opinion, essentially the opinion of five justices, is dispositive only of the liability created by Chiarella's legal relationship (or non-relationship) to target shareholders. The Court did not decide whether Chiarella breached a duty to the acquiring corporation since that theory was not properly submitted to the jury. Several other issues related to the scope of federal control over insider trading were left unresolved. A future Chiarella might not be permitted to exploit confidential information with impunity.

A critical analysis of Chiarella is necessary lest it be construed as definitive and controlling precedent. The purpose of this comment is to clarify those propositions which survive the decision, and to examine the competing philosophies associated with rule 10b-5. First, some historical background is necessary in order to place the Exchange Act and rule 10b-5 in their proper perspective.

**Origin of the Overall Scheme to Regulate Securities Transactions**

Both the Securities Act of 1933 and the Exchange Act of 1934 were enacted during the years of economic depression and faithlessness which followed the stock market crash of 1929. The Acts were legislative attempts to restore public confidence in the financial markets of the United States by curbing the unsavory business practices which characterized the 1920's. Broadly speaking, the Securities Act regulates the ini-

19. The views expressed in Justice Brennan's separate concurring opinion are philosophically at odds with those expressed by the majority. See notes 131-2 and accompanying text infra.

20. Chiarella's principal defense at trial was the absence of an intent to defraud. The Court, however, did not charge the jury that specific intent was a requisite element of the crime. Brief for the Petitioner at 49, United States v. Chiarella, 99 S. Ct. 2158 (1979).

Further, the jury was not instructed as to the nature or the elements of the duty owed by Chiarella to anyone other than the target company. Therefore, whether or not he breached a duty to the acquiring company (Pandick's customer) was not addressed by the Supreme Court. See 445 U.S. at 236.


22. See J. BROOKS, THE SEVEN FAT YEARS: CHRONICLES OF WALL STREET 169 (1958). In the years immediately preceding the passage of federal securities law, the Wall Street businessman was publicly perceived as an unsavory character: a "bloated cigar-smoking plutocrat wearing a top hat, a cutaway, striped pants, and a dollar sign for a watch fob as he tramples on widows and orphans."

23. See, e.g., H.R. REP. No. 1383, 73d Cong., 2d Sess. 5 (1934):

If investor confidence is to come back to the benefit of exchanges and
tial distribution of corporate securities to the investing public. The principal focus of the Exchange Act, of which section 10(b) is a part, is the regulation of securities trading after initial issuance.\textsuperscript{24} Collectively, the federal securities laws were designed to protect the investing public by fostering the dissemination of relevant information\textsuperscript{25} and by prohibiting manipulative and deceptive practices which might artificially and dishonestly affect the market price of securities.\textsuperscript{26} The Securities Act and the Exchange Act are both administered by the Securities and Exchange Commission.

\textit{Legislative History of Section 10(b)}

Section 10(b) of the Exchange Act is acknowledged as a largely judge-made federal law of corporations.\textsuperscript{27} The legislative history of the provision is scant and notably unrevealing as to its intended scope and application.\textsuperscript{28} As a result, judges have been


25. That design is frequently articulated in the specific context of 10b-5 application to nondisclosure cases. See, e.g., Shapiro v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 495 F.2d 228, 235 (2d Cir. 1974) (rule 10b-5 was enacted to promote “full disclosure of inside information so that an informed judgment can be made by all investors who trade . . . .”); Crane v. Westinghouse Air Brake Co., 419 F.2d 787, 793 (2d Cir. 1969), cert. denied, 400 U.S. 822 (1970) (purposes of the Exchange Act include protection of the investing public from manipulative and deceptive devices which mislead traders and which preclude fair and open dealing in the securities markets).

26. See 77 CONG. REC. 2918 (1933). Representative Rayburn expressed this overall policy of preserving the integrity of the marketplace on behalf of investors just prior to passage of the Securities Act: “The purpose of this bill is to place the owners of securities on a parity, so far as is possible, with the management of the corporations, and to place the buyer on the same plane so far as available information is concerned, with the seller . . . .” Id. The Congressman reiterated this view the following year: “We should have a marketplace for the exchange of securities, but it should be a clean and honest market place.” 78 CONG. REC. 7697 (1934). The importance of adequate disclosures of relevant information to investors is further discussed in Fleischer, \textit{Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding}, 51 VA. L. REV. 1271, 1279 (1965).


28. JACOBS, supra note 9, at § 5.
relatively free to interpret the provisions as they believe justice demands.

What little is known of the legislative purpose behind section 10(b) has been gleaned from the House and Senate floor debates. The language now contained in section 10(b) was originally submitted as section 9(c) of the bills introduced to Congress.29 J.M. Landis, a Commissioner of the Federal Trade Commission30 and draftsman of the Exchange Act, was the initial witness before the House Committee on Interstate and Foreign Commerce. He explained that section 9(c) conferred a general power upon the Commission to proscribe any “manipulative device.”31 Thomas G. Corcoran, the administration’s principal spokesman, also testified as to the breadth of proposed section 9(c) and coined it a “catch-all clause” to prevent manipulative devices not within the immediate contemplation of the draftsmen.32

The section’s broad grant of power prompted a number of objections, and a modified version which omitted reference to manipulative or deceptive devices was introduced to Congress. However, the final draft of section 10(b) emerged from the conference committee with the original prohibitions against manipulative and deceptive devices intact.


30. The Federal Trade Commission was the SEC’s predecessor and administered the 1933 Act until 1934.

31. One of the most serious abuses in the securities markets on which Senate investigators focused in the hearings which led to the enactment of the 1934 Act, was the operation of “pools” which ran up the prices of securities on an exchange by a series of well-timed transactions, effected solely for the purpose of “manipulating” the market price of the security. The combination of persons or corporations comprised by the pool would then unload its holdings on the public just before the price dropped. Other manipulative devices typically employed in the context of tender or exchange offers include: trading during a tender offer to induce others to buy or to sell; making a tender offer without adequate funds to pay for the tendered stock; and public misrepresentation by a tender offeror to the effect that it will not make the offer and will unload the target company’s stock on the open market. The foregoing list is far from exhaustive. For a more detailed analysis of stock market manipulation, see Jacobs, supra note 10, at § 139. Note also that section 10(b) was wisely worded in the broadest terms. The drafters realized that the most dangerous species of fraud may have yet to be invented.

32. Hearings on Stock Exchange Regulation Before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 21 (1934). Corcoran is quoted as stating:

Subsection (c) says, “Thou shalt not devise any other cunning devices.” Of course subsection (c) is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices. Id.
Administrative History of Rule 10b-5

Section 10(b), by its terms, was inoperable without a complementary rule of enforcement. Prior to the adoption of rule 10b-5 in 1942, the Commission was without authority to censure frauds by purchasers other than brokers and dealers.33 The operative language of section 17(a) of the Securities Act 34 is almost parallel to that contained in 10(b). Section 17(a), however, prohibits only the fraudulent sale of securities.35 No comparable provision proscribed fraudulent practices in connection with the purchase or sale of securities. Rule 10b-5 was promulgated to implement section 10(b) and to close this gap in the federal antifraud provisions.36

Beyond the manifest intent to extend federal protection to sellers of securities, the congressional policies which underly rule 10b-5 cannot be elicited from its sketchy legislative history.37 The guiding principles which broaden or delimit the scope of the rule derive primarily from case law. Consequently, the rule's potency as an antifraud device is largely determined by the federal courts.38

JUDICIAL EXPANSION OF INSIDER LIABILITY UNDER RULE 10b-5

The drafters of the federal antifraud provisions were clearly motivated by a need to curb the misuse of relevant investors' information unavailable to the general public.39 Rule 10b-5 does not specifically require disclosure of facts known to one party to a securities transaction and unknown to the other.40 The cases

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33. Section 15 of the Exchange Act affords protection to both buyers and sellers of securities but its prohibitions are limited to fraudulent practices by brokers in the over-the-counter market. 15 U.S.C. § 78(o) (1976).
36. Section 17(a) was enacted during a period of economic depression and was responsive to the plight of the innocent purchaser of overpriced securities. Economic recovery resulted, more typically, in the purchase of under-priced securities by unlucky sellers. Thus, section 17(a) may be considered a depression rule and 10(b) may be considered a prosperity rule. Jacobs, supra note 10, at § 5.
38. Id.
40. Clause (2) refers to omissions to state material facts only when nec-
have uniformly held, however, that if the party in exclusive possession of material\textsuperscript{41} information occupies a fiduciary relationship to the other party to the transaction, rule 10b-5 imposes an affirmative duty to disclose or abstain from trading.\textsuperscript{42} This fiduciary obligation is usually said to arise where one of the parties is a "corporate insider."\textsuperscript{43} The courts have had no difficulty in holding officers, directors,\textsuperscript{44} and majority or controlling shareholders\textsuperscript{45} to the standards required of corporate insiders. The difficult and much litigated issue is: Does the disclose or abstain rule extend to individuals or groups operating outside the corporate structure, but with special access to inside corporate information?

In \textit{In Re Cady Roberts & Co.},\textsuperscript{46} the SEC held a broker-dealer liable under rule 10b-5 because he purchased stock for preferred

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\item essary "to make the statements made . . . not misleading" and neither clause (1) nor clause (2) specifically address the duty to disclose.
\item 41. See note 14 supra.
\item 42. The "disclose or abstain" rule was first enunciated in \textit{SEC v. Texas Gulf Sulphur Co.}, 401 F.2d 833, 848 (2d Cir. 1968) \textit{(en banc)}, cert. denied, 394 U.S. 976 (1969). The rule requires that: "[A]nyone 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 . . . must abstain from trading in or recommending the securities concerned while such information remains undisclosed."
\item The courts at common law split as to whom the fiduciary duty to disclose was owed. The majority rule was that corporate insiders owed fiduciary duties to the corporation, not to individual shareholders. Hence, there was no duty of disclosure to shareholders regarding any inside information which might affect the value of the shares. "Caveat emptor" applied. \textit{Goodwin v. Aggasiz}, 283 Mass. 358, 186 N.E. 659 (1933). A minority of the common law courts held that there was a duty of disclosure to shareholders. \textit{See King Mfg. Co. v. Clay}, 216 Ga. 581, 118 S.E.2d 581 (1961).
\item The \textit{Texas Gulf Sulphur} case left little doubt that other corporate employees might be liable as insiders even though they were not corporate executives. By way of analogy, any person regularly employed by the corporation and privy to corporate information falls within the definition of a corporate insider. \textit{Cf. Fischer v. Kletz}, 266 F. Supp. 180 (S.D.N.Y. 1967) (accountant held liable for failing to disclose after-acquired information that the financial statement he prepared for his corporate employer was false.)
\item 45. \textit{Speed v. Transamerica Corp.}, 99 F. Supp. 808 (D. Del. 1951) (a majority stockholder's duty of affirmative disclosure to minority stockholders with whom he deals, stems from the necessity of preventing a corporate insider from using his position to take advantage of uninformed minority stockholders); \textit{Robinson v. Difford}, 92 F. Supp. 145 (E.D. Pa. 1950) (under section 10(b), a minority stockholder has a right of action against a majority stockholder who induces him to purchase shares for substantially less than their true value).
\item 46. 40 S.E.C. 907 (1961).
\end{itemize}
accounts on the basis of inside information received from a director of the issuing corporation. Unquestionably, the director-informant would have been compelled to abstain from trading prior to public disclosure of the news he revealed to the broker-dealer. In Cady, the SEC extended liability to the broker-dealer as well, maintaining that the duty to disclose or abstain was triggered by "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." Thus, according to the Cady analysis, officers, directors, and controlling stockholders do not exhaust the class of persons subject to the disclose or abstain rule.

Cady paved the way for expansion of rule 10b-5 in another respect. It eliminated the necessity of proving the common law elements of fraud and deceit. Arguably, Cady preserves the requirement that rule 10b-5 liability for nondisclosure be premised upon a special relationship between the parties to the transaction, but not necessarily upon a fiduciary relationship by common law standards.

The concept of the corporate insider was further extended in SEC v. Texas Gulf Sulphur Co. The defendants in Texas Gulf were corporate executives and employees who became privy to the startling results of Texas Gulf drilling in Ontario. Before news of a highly promising ore discovery was adequately disclosed to shareholders, certain individual defendants purchased large amounts of the stock or "calls" for their per-

47. Id. at 908-09.
48. Id. at 912. A further justification for extension of the disclose or abstain rule to a non-corporate or "quasi" insider is the inherent unfairness of permitting a party to take advantage of information he knows is unavailable to those with whom he is dealing.
49. Id. at 911.
50. Id. at 912.
51. Id. at 910 n.8. Rule 10b-5 is described as a broad remedial provision aimed at reaching misleading or deceptive activities "whether or not they are precisely and technically sufficient to sustain a common law action for fraud and deceit."
52. See Barnet, supra note 35, at 284 n.36; see also SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).
53. 401 F.2d at 843-48. Texas Gulf Sulphur was a corporation engaged in, among other things, the exploration and mining of certain minerals. The promising results of the drilling expedition in Ontario, Canada showed the area to be a rich source of copper, zinc, and silver.
54. A "call" is a negotiable option contract by which the bearer has the right to buy from the writer of the contract, a certain number of shares of a particular stock at a fixed price on or before a certain agreed upon date. The very nature of a call is highly suggestive of the fact that defendants who purchased them were almost dead certain the stock would go up.
Market Insider Liability

sonal accounts. The Second Circuit ruled that anyone in possession of material, inside information is an insider within the meaning of the federal securities laws and must therefore disclose that information or refrain from trading.

The court found it unnecessary to premise the duty to disclose upon any special relationship, and instead took the position that it is superior access to material, inside information which triggers the duty to disclose. The Second Circuit thus embarked upon a more radical departure from common law standards of liability than had the earlier Cady court.

Texas Gulf Sulphur forged ground for still another dimension of prohibited conduct under rule 10b-5. Two of the individual defendants had "tipped" news of the ore strike to certain outsiders who proceeded to purchase corporate shares. The defendants were held liable for the profits made by their tippees. Thus, an insider can be held liable for conveying nonpublic information to third persons who in turn trade on the basis of such

55. 401 F.2d at 843-44.
56. Id. at 849. Facts having a bearing upon the probable future of a company and therefore crucial to an individual's decision to buy, sell or hold the company's securities were deemed to be just as material as facts disclosing the earnings and distribution of the corporation. Whether or not a fact was material under rule 10b-5 would depend upon a balancing of both the probability that the event would occur and its anticipated magnitude in light of the company's overall activities. Id.
57. 401 F.2d at 848. The court rested its holding on the conclusion that "the rule is based on the justifiable expectation of the marketplace that all investors . . . have relatively equal access to material information." The position espoused by the Second Circuit, that equality of information was the legislative intent behind 10b-5, is in contention with the theory that the purpose of 10b-5 was to prohibit corporate insiders from abusing their positions of trust. Barnet, supra note 35, at 824-25.
58. 40 S.E.C. at 912. Cady specifically referred to a "relationship" that gave access to inside information. Apparently, the Texas Gulf Sulphur court relied exclusively upon the "access" aspect of the Cady test.
59. "Tipping" is defined as the selective disclosure of material inside information. See Faberge, Inc., Exchange Act Release No. 10174 (1973); Investors Management Co., Exchange Act Release No. 9287 (1971). Thus, if an insider conveys material inside information to a third party, the insider is a tipper, the third party is his tippee. The SEC has indicated that a tippee need not know or have reason to know that the tipped information is nonpublic to incur liability. In re Cady, Roberts & Co., 40 S.E.C. 907, 912 n.17 (1961); accord, Comment, Deterrence of Tippee Trading Under Rule 10b-5, 38 U. Chi. L. Rev. 372, 386-84 (1971). But see Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264, 273 (S.D.N.Y. 1972), which requires knowledge of materiality as an element of plaintiff's case.
60. An individual who obtains a pipeline to material inside information from corporate personnel and uses such information for his own profit can be held liable as a tippee under rule 10b-5. Although a tippee incurs the disclosure obligations of an insider, he is distinguishable from the latter in that he does not have a legitimate business reason for knowing the inside information. Jacobs, supra note 9, at § 66.02(a). To incur liability, a tippee must have reason to know that the tipped information is nonpublic.
information before it is made public. Liability accrues whether or not the insider trades with the informational edge.\textsuperscript{61}

Persons who purchased Texas Gulf stock and calls on the basis of tips received from insiders were not named as defendants in the SEC complaint. Despite the fact that the issue of tippee liability was not directly before the Texas Gulf court, Judge Waterman cautioned that one who trades on a tip is as culpable under rule 10b-5 as is the insider who transmits the tip.\textsuperscript{62}

The Second Circuit had the opportunity to squarely address this issue in \textit{Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.}\textsuperscript{63} As a prospective underwriter for a new issue of Douglas Aircraft Company stock, Merrill Lynch became privy to an unfavorable forecast of the plaintiff company's earnings.\textsuperscript{64} Defendant leaked this news to certain preferred customers who unloaded their shares before the news was publicly announced.\textsuperscript{65} The Second Circuit ruled that these trading tippees violated rule 10b-5 because they knew or should have known the confidential nature of the information. The Commission also censured Merrill Lynch\textsuperscript{66} whose liability could have been predicated on either insider or tippee status.\textsuperscript{67}

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\item \textsuperscript{62} 401 F.2d at 853. Cases subsequent to \textit{Texas Gulf Sulfur} have settled the issue of tippee liability. \textit{See}, e.g., Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 887, 890 (2d Cir. 1972) (one in possession of material inside information, "be he an insider or tippee . . ." must disclose that information or abstain from trading); Kuehnert v. Texstar Corp., 412 F.2d 700, 702-05 (5th Cir. 1969) (invoked the clean hands doctrine to bar suit by a tippee who suffered losses as a result of false and misleading inside information); Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967) ("tippees are subject to the same duty as insiders. . . .")
\item \textsuperscript{63} 495 F.2d 228 (2d Cir. 1974).
\item \textsuperscript{64} \textit{Id.} at 232. The revised earnings report projected a sharp decrease in earnings for 1966, with a potentially "no profit" situation accruing, and a substantially decreased projected earnings for 1967.
\item \textsuperscript{65} Within four days, defendant tippees had sold more than 165,000 shares of plaintiff's stock on the New York Stock Exchange. This was nearly one half of the total shares traded. The rash of selling caused a dramatic decline in the market price of Douglas stock. \textit{Id.} at 233.
\item \textsuperscript{67} It seems reasonable to regard Merrill Lynch as an insider since, as plaintiff's underwriter, it had a duty to disclose all material, inside information about the corporation. \textit{See} \textit{Jennings & Marsh, supra} note 24, at 948 n.15. It is conceivable though, that Merrill Lynch might itself be regarded as a tippee who in turn tipped favored customers. The latter would thus comprise a group of "remote tippees." Theoretically, tippee liability under rule 10b-5 could extend to all persons who profited on trades traceable to the original tip. To date, however, the courts have declined to impose liability
Thus far, rules of insider trading have been applied to individuals other than traditional corporate insiders only if those individuals have some connection with an inside source of information. Absent some pipeline to a corporate source, it is doubtful that insider liability under 10b-5 would attach. In *Mills v. Sarjem Corp.*, for example, a syndicate purchased all the stock of a private company which owned two toll bridges across the Delaware River. It then resold the stock at a price roughly twice what it had paid. Former shareholders brought suit claiming that the syndicate had fraudulently manipulated corporate assets, but were denied recovery under rule 10b-5 because the scheme was conceived by an "outsider" and not on the basis of inside information.

At some point, however, an outsider who plans to obtain control of a corporation becomes an insider. Under the Williams Act, a tender offeror is required to disclose the planned acquisition to target shareholders once it has accumulated five percent of the target’s outstanding stock or has begun to negotiate with the target’s board of directors and thus been exposed to inside corporate data. The scope of the terms “insider” and “tippee” depends in part, therefore, on the concept of inside information.

**The Concept of Market Insider Liability Under 10b-5**

To illustrate potential situations in which market insider liability under rule 10b-5 may accrue, consider the following hypotheticals. Management may know that a favorable analysis of Conglomerate Company along with a recommendation to buy its stock is about to be released by a top-notch brokerage firm. Dis-
The closure of this information would precipitate an immediate market reaction. The price of shares would adjust to reflect the public's increased interest in the company. Knowledge that Conglomerate will shortly split its stock, or that a wealthy individual has offered to buy a block of its shares at a price above the premium, if communicated, would become a market stimulant. Similarly, anyone who knows of Conglomerate's plan to acquire Target Company has information which, if revealed, would stimulate market trading.

Material, nonpublic market information is present in each of the above cases. Market information relates to the phenomenon of supply and demand. It is distinguishable from inside corporate information in that it has an influence upon the value of a corporation's shares which is wholly independent of any structural or internal change within that corporation. For instance, investors who know that Conglomerate is about to be highly recommended take a minimal risk if they purchase its stock. They can readily predict a jump in the price of Conglomerate shares and have a distinct advantage over other traders if they invest before the recommendation appears. No change in Conglomerate's earning power or the value of its assets has enhanced its desirability as a purchase; it is the fact of the forthcoming recommendation which appreciates the value of Conglomerate stock.

Not all market information is inside information. In fact, because it is most often generated by forces outside the company whose shares are affected, market information is normally accessible to anyone. There are a variety of ways, however, in

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75. See, e.g., Hausman, West, & Largay, Stock Splits, Price Changes, and Trading Profits: A Synthesis, 44 J. Bus. 69 (1971). See also Hafner v. Forest Labs., Inc., 345 F.2d 167 (2d Cir. 1965). In Hafner, a corporation's failure to disclose an impending four percent stock dividend to a shareholder from whom it repurchased shares was held not to be a violation of rule 10b-5 because the dividends would not have given plaintiff any greater equity interest in the corporation. In dicta, however, the court asserted that under appropriate circumstances, knowledge of a stock dividend would be material market information. The case stands for the proposition that dividends and stock splits have potential market importance.

76. See, e.g., Reed v. Riddle Airline, 266 F.2d 314, 315, 319 (5th Cir. 1959) (insider failed to disclose that a wealthy individual was interested in purchasing shares where those purchases caused an increase in the price of stock).

77. See Fleischer, Mundheim & Murphy, An Initial Inquiry into the Responsibility to Disclose Market Information, 121 U. PA. L. REV. 798, 810 (1973) [hereinafter cited as Fleischer].

78. Id. at 799.

79. Id.
which market information may become inside information. Market information may be selectively released by someone outside the corporation to someone inside, as where management receives prior notice of the broker's recommendation. Or, corporate insiders may have prior access to market information which they themselves generate. Illustrative, is management's knowledge of its own decision to announce a stock split or the repurchase of outstanding shares.  

As long as the recipients of material, nonpublic market information occupy a position inside the issuing company, trading in advance of disclosure is clearly in breach of a fiduciary duty owed shareholders. Liability under rule 10b-5 attaches as if the trade were based on secret information about the corporation itself. The distinction between market and corporate information in such a case is immaterial. The more difficult question is whether rule 10b-5 is properly invoked to control trades by outsiders who obtain their information at the marketplace and not from a corporate source.

Nonpublic market information is routinely available to market professionals such as brokers, dealers, and exchange members. The activities of these specialists are, however, closely monitored by the SEC. Moreover, availability of nonpublic market information to specialists is justified to the extent that it is used to stabilize and protect the marketplace.

A different situation arises when a nonspecialist becomes intimate with the functioning of the marketplace and competes with an informational edge. Public policy does not justify this individual's use of nonpublic information. The point is neatly illustrated where a third person discovers the target of a corporate acquisition plan before it is publicly announced. It has been argued that trading with such an informational advantage amounts to insider trading and is contrary to the policies which underly rule 10b-5.  

80. See generally Fleischer, supra note 77, at 840-45.
81. The 1934 Act § 11(b) provides:
   "If under the rules and regulations of the Commission a specialist is permitted to act as a dealer, or is limited to acting as a dealer, such rules and regulations shall restrict his dealings so far as practicable to those reasonably necessary to permit him to maintain a fair and orderly market...."
82. See SEC v. Campbell, [1972] Fed. Sec. L. Rep. (CCH) ¶ 93,580 (C.D. Cal. 1972) (Campbell, a financial columnist, "scalped" his own column. That is, he purchased shares in certain companies and then wrote favorable articles about those companies intending to benefit from the anticipated price rise). Cf. In re Blythe & Co., Inc. [1969] Fed. Sec. L. Rep. (CCH) ¶ 77,647. Blythe was found to have violated rule 10b-5 by trading in government securities while in possession of material nonpublic information con-
The classification of certain traders as market insiders may well be appropriate. For purposes of imposing an affirmative duty of disclosure, there seems no reason to distinguish between a trade based upon an individual's superior access to the market and a trade based upon a corporate executive's superior access to facts about his own business. If measured by the immediate impact on stock price alone, these transactions are equally damaging to the uninformed investor.

The problems of identifying insiders and defining inside information bring the issue of the Chiarella case sharply into focus: Is there a point at which a corporate outsider with regular access to inside information becomes a market insider within the reach of rule 10b-5? The law in the area has not yet hardened and judges continue to decide the issue according to their personal theories about why the rule was promulgated. The fundamental conflict is between those judges who believe that the rule was designed to democratize the marketplace by providing investors with relatively equal access to information, and those who believe that the rule was, more specifically, intended to prevent abuses by corporate insiders.

**Preface to the Chiarella Case**

Chiarella was not a director, officer, or majority shareholder of either the acquiring corporation or its target, nor had he been tipped by a corporate insider. Chiarella could not, therefore, be cast in the traditional role of a corporate insider.\(^8^3\) Chiarella obtained his informational edge through a combination of resourcefulness and strategic positioning within the marketplace.\(^8^4\) Both parties conceded that Chiarella had converted confidential information from the corporation that entrusted the printing firm with their documents.\(^8^5\) The theory upon which Chiarella successfully defended, however, was that absent a special relationship to other traders and investors, rule 10b-5 would not apply.

The Chiarella case presented a perfect opportunity for the Supreme Court to crystallize the parameters of rule 10b-5. Unfortunately, the Court did not address whether Chiarella could cerning the terms of a new government issuance. *Id.* at ¶ 83,398. See also Jacobs, *supra* note 9, at § 66.02.

83. *See* notes 44-45 *supra*.

84. *See* notes 9-12 *supra*.

have been convicted on a theory that he breached a fiduciary
duty to the acquiring corporation. Chiarella might have been
implicated on that theory under common law agency princi-
pies. An agency link between Chiarella and the acquire-
ner might have supplied the special relationship which, according
to the majority, is an indispensable element of a rule 10b-5 of-
fense. Even had the existence of an agency relationship been
established, however, the fact that the acquirer was neither a
purchaser nor seller of target company securities might have
provided an alternate basis for the ruling that no actionable vi-
olation of 10b-5 had occurred.

Chiarella also raised, without deciding, the issue of whether
rule 10b-5 is violated where one fails to disclose market informa-
tion as opposed to information concerning the corporation it-
self. It is doubtful that Chiarella was a “tippee” within the
meaning of the statute. Tippee status usually arises from one’s
participation after the fact of an insider’s breach of a fiduciary
duty. Chiarella was, however, in the nonlegal sense of the
word, tipped off to market information by virtue of his continued
exposure to corporate data. Chiarella’s critical position within
the marketplace raises important questions regarding his status
under the securities laws. At what point should one with such
exposure be considered privy to the corporation? To what ex-
tent does one with superior access to market data become a
market insider? Are market insiders subject to the strictures of
rule 10b-5? Unfortunately, the Chiarella opinion does not satis-
factorily put these issues to rest.

Assume, hypothetically, that Chiarella had been found lia-

able as an agent of the acquiring corporation: Would agency sta-

tus have formed the basis for liability to the target company? In
other words, as its agent, would Chiarella have been sufficiently
“inside” the acquiring corporation to justify an imposition of the
same rules of disclosure which applied to the tender offeror?

The foregoing observations should alert the reader to the
tapestry of intriguing issues raised by the Chiarella case. The
following is an analysis of how the case was decided at each
level of appeal.

87. Brief for the United States Government at 35, Chiarella v. United
States, 445 U.S. 222 (1980). See also RESTATEMENT (SECOND) OF
AGENCY §§ 395, Comments a, c; 393 Comment a; 390 & Comment a; 388 (1933).
88. 445 U.S. at 231-32.
90. See note 87 supra.
91. 445 U.S. at 230 n.12.
Evolution of the Case

An investigation of Chiarella's trading activities was initiated by the SEC in May, 1977. Pursuant to a consent decree,\(^9\) Chiarella was compelled to disgorge his ill-gotten profit and divide it among the persons from whom he had purchased target corporation shares.

Despite civil sanctions, Chiarella was indicted\(^9\) by a federal grand jury on seventeen counts\(^4\) of securities fraud for trading in violation of section 10(b) and rule 10b-5 of the Exchange Act. The defense moved to dismiss the indictment on the ground that it failed to charge Chiarella with a crime.\(^5\)

The district court denied defendant's motion to dismiss\(^6\) and found Chiarella guilty on each count.\(^7\) The finding of fraud was two-fold. In the first instance, Chiarella's misappropriation of corporate secrets was compared to embezzlement by a bank employee\(^8\) and declared to be a fraud upon the offeror corporations.\(^9\) In addition, the district court found that Chiarella's failure to disclose material facts had tainted the transaction with an "inherent unfairness"\(^10\) and consequently was a deceptive practice within the meaning of rule 10b-5.

Speaking for the Second Circuit Court of Appeals, Judge Kaufmann affirmed the lower court and maintained that the antifraud provisions of the Exchange Act were designed to promote equal access to market information among investors.\(^10\) As the regular recipient of nonpublic information, Chiarella was

\(^9\) 588 F.2d at 1364.

\(^9\) The indictment was brought pursuant to the penalty provision of section 32(a) of the 1934 Securities Exchange Act, 15 U.S.C. § 78 FF(a) (1976).

\(^4\) 588 F.2d at 1364. Each represents one of Chiarella's seventeen individual purchases of target company stock.


\(^6\) 450 F. Supp. at 95.

\(^7\) 588 F.2d at 1364 n.7. Chiarella was sentenced to one year imprisonment but the sentence was suspended after one month and he was placed on five year probation.

\(^8\) 450 F. Supp. at 96.

\(^9\) Id. at 97. This position was supported by the fact that Chiarella's purchases created an artificial demand in the target company's stock thus inflating its price and potentially frustrating the plans of the acquiring corporation.

\(^10\) See In re Cady, Roberts & Co., 40 S.E.C. at 912. The phrase "inherent unfairness" was first used to describe trading on nonpublic information by officers, directors and controlling shareholders.

deemed to be a market insider,\textsuperscript{102} and accordingly, was under an affirmative duty to disclose to the target sellers.\textsuperscript{103}

Judge Meskill, in a vigorous dissent, argued that the majority had usurped both the legislature's and the SEC's functions by creating the new category of market insider.\textsuperscript{104} His chief objection, however, was the inappropriate, retroactive effect which the unprecedented extension of criminal liability\textsuperscript{105} under rule 10b-5 would have upon market insiders such as the defendant.\textsuperscript{106}

\textbf{ANALYSIS OF THE SUPREME COURT'S POSITION}

\textbf{The Special Relationship Test}

Justice Powell narrowly framed the issue according to the specific facts of the case: Does one who has learned from the confidential documents of one corporation of plans to secure control of a second corporation violate section 10(b) of the Exchange Act if he fails to disclose the impending takeover before trading in the target company's securities?\textsuperscript{107} There is no unequivocal answer to that question in the opinion. What does emerge from the opinion is a philosophy of fraud under section 10(b) of the Exchange Act. In defining those circumstances which trigger a duty to disclose under section 10(b) and rule 10b-5, Justice Powell adopted the common law doctrine of fraudulent misrepresentation—there can be no fraud absent a duty to

\textsuperscript{102} 588 F.2d at 1364. Although Chiarella did not hold a position inside the corporation, he was constantly exposed to sensitive and confidential corporate information by virtue of his strategic position inside the market. For a more detailed analysis of the market insider, see Fleisher, \textit{supra} note 77, at 845-50.

\textsuperscript{103} 588 F.2d at 1365.

\textsuperscript{104} \textit{Id.} at 1376-77 (Meskill, J., dissenting).

\textsuperscript{105} Willful violations of the securities laws or the rules promulgated under them are punishable by fine and imprisonment. The Commission does not prosecute criminal cases itself, but transmits the evidence to the Justice Department, which decides whether to prosecute. \textit{See} note 13 \textit{supra}. Defendant need not know that he acted in violation of the securities laws in order for his conduct to be considered willful. A showing of negligence, however, would be insufficient to sustain a conviction. \textit{See} United States v. Koenig, [1974] Fed. Sec. L. Rep. (CCH) ¶ 94,765 (S.D.N.Y. 1974). The courts have consistently rejected arguments by defendants that various provisions of the securities laws are unconstitutionally vague as the basis for criminal prosecutions. \textit{See}, e.g., United States v. Wolfson, 405 F.2d 779 (2d Cir. 1968).

\textsuperscript{106} For a discussion of the proposition that the Second Circuit's interpretation of rule 10b-5, though a proper expansion of the rule, was unconstitutionally applied in Chiarella, see \textit{Chiarella}, \textit{Rule 10b-5: Birth of the Concept of Market Insider & its Application in a Criminal Case—United States v. Chiarella}, 8 FORD. URB. L.J. 468 (1979).

\textsuperscript{107} \textit{Chiarella} v. United States, 445 U.S. 222, 224 (1980).
He expressly rejected the theory upon which Chiarella was convicted. Rather, he maintained that the duty to speak arises from a relationship between the parties and not merely from one's superior ability to acquire information because of his position in the market.\(^{109}\)

Powell's refusal to extend liability under rule 10b-5 to market insiders such as Chiarella may reflect the same fear which was expressed by Judge Meskill in the court below,\(^{110}\) viz., a fear that the expansion of securities laws might inhibit the productive activities of the "whole corporate universe."\(^{111}\) Perhaps, for that reason, he adhered to the argument that federal courts are simply "not at liberty to legislate" a different result from that which Congress has ordained.\(^{112}\) The possibility that Powell may have been motivated by policy considerations is arguable because the statute is capable of a much broader construction than he permits.\(^{113}\)

Powell's analysis commenced with an acknowledgment that neither the language of the statute nor its legislative history specifically addresses the consequences of a failure to disclose material information under rule 10b-5. Powell then demonstrated that case law resolution of the issue has largely reflected the notions of fiduciary responsibility developed under state and federal law. Focusing on the "relationship" aspect\(^{114}\) of the Cady opinion, Powell interpreted it as an outgrowth of the common law of fraud and deceit.

Although the facts surrounding Cady did not necessitate departure from a theory of liability based on common law principles of fiduciary responsibility, the SEC set the stage for expansion of the rule beyond the common law. Rule 10b-5 was described as a broad remedial provision aimed at reaching misleading or deceptive activities "whether or not they are precisely

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\(^{108}\) Id. at 232.

\(^{109}\) Id. at 233.


\(^{111}\) Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) citing 588 F.2d at 1377. It is submitted in response to the court's "fear," that federal regulation of the type of fraud at issue in Chiarella, would in no way undermine the productive activities of market specialists. A requirement that market players share nonpublic information which they have no bona fide business need to conceal would not preclude the market specialists from taking full advantage of an informatoinal edge which is the result of skill, acumen, and insight.


\(^{113}\) See notes 32-33 supra. The drafters clearly intended to give the SEC and the courts ample room to catch fraud.

\(^{114}\) 445 U.S. at 227-8.
and technically sufficient to sustain a common law action for fraud and deceit." Thus, rule 10b-5 could apply without regard to the common law requirement of privity between the parties to the transaction.

Powell cited *Texas Gulf Sulphur* in support of the proposition that there must be a duty to disclose before one is obligated to do so. The court in *Texas Gulf Sulphur*, however, relied upon the "access" aspect of the Cady rule, suggesting that access alone was enough to trigger the duty to disclose or abstain from trading.

Additionally, Justice Powell relied upon *Affiliated Ute Citizens of Utah v. United States* in support of his principal thesis that the duty to disclose must be premised on a special relationship. In *Affiliated Ute*, the defendants, like Chiarella, were not traditional corporate insiders, tippees, or broker dealers. The Court was, however, able to premise liability upon a special relationship between the parties. Albeit technically dicta, the Court strongly suggested that those who have a relationship with the functions of the market meet the special relationship test. The *Ute* Court perceived rule 10b-5 as inclusive and opined that "its fundamental purpose is to substitute a philosophy of full disclosure for the philosophy of caveat emptor, and thus to achieve a high standard of business ethics in the securities industry."

Powell concluded from this prior case law that the failure to disclose material, market information might be actionable as fraud under section 10(b) even in the absence of express statutory language addressing such nondisclosure. He again urged,

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117. 401 F.2d at 848.
119. *Id.* at 152. *Affiliated Ute* involved a bank which had agreed to act as a transfer agent for the Ute Development Corporation (UDC). The UDC was formed pursuant to the Ute Partition act of 1954 and provided for the distribution of Ute assets to tribe members. Two bank employees went beyond their roles as transfer agents. They bought Ute stock for their own accounts and then sold it in a secondary market at a substantially higher price. Mr. Justice Blackmun, writing for the majority of the Court, stated that had the bank functioned solely as a transfer agent, no duty of disclosure would have arisen. Because the Bank had agreed to supervise transactions and ensure their compliance with UDC rules, it acquired fiduciary obligations to its Ute customers.
120. *Id.* at 152-53. The fact that defendants acted as market makers clearly influenced Blackmun's determination that a duty of disclosure had arisen. *See* Fleischer, *supra* note 77, at 819-20.
however, that liability must spring from a relationship of trust and confidence between the parties.

Powell distilled two principal flaws from the appellate court's conclusion that a market insider with regular access to corporate secrets falls within the purview of rule 10b-5: first, that "not every instance of financial unfairness constitutes fraudulent activity under section 10(b)," and second, that because Chiarella was neither an agent nor a fiduciary of the issuer corporation, "the element required to make silence fraudulent—a duty to disclose—was absent from the case." Powell also stated that disparity of access to information between the parties to a transaction was not, as the Second Circuit concluded, the crux of the offense. The Williams Act, which qualifiedly allows corporations to use nonpublic information, was submitted as evidence that Congress never intended a parity of information rule.

In fact, the acceptance of such practices by the SEC should allay fears that an extension of rule 10b-5 to certain market insiders would interfere with the routine activities of traders. The provision signifies sensitivity to the needs of the securities industry but is not inconsistent with attempts to restrict the use of misappropriated market information.

Finally, Justice Powell voted to reverse the circuit because the government’s argument that Chiarella had breached a duty to the acquiring corporation and his employer was not properly presented to the jury. Powell did not address Chiarella’s potential liability for breach of duty to the acquiring corporation. The opinion clearly indicates Powell’s reluctance to create a new category of market insiders and a present concern that further extension of the securities laws might ultimately preclude the market professional from taking advantage of his expertise and the knowledge of his own objectives. The tone of the opinion casts doubt upon whether Powell would have sustained a

123. 445 U.S. at 233.
124. See also General Time Corp. v. Talley Indus., Inc., 403 F.2d 159 (2d Cir. 1968), cert. denied, 393 U.S. 1026 (1969). The court found that defendant Talley did not violate rule 10b-5 by purchasing up to five percent of the target company’s securities without disclosing his plans for a merger. Note that the General Time decision came down prior to enactment of the Williams Act.
125. See note 113 and accompanying text, supra. It is again urged that public policy does not dictate the extension of General Time benefits to Chiarella. He took no economic risk and his purchases were not the result of a legitimate analysis of the marketplace.
126. 445 U.S. at 237.
conviction of this particular defendant under any circumstances.

Justice Stevens concurred with the Powell mandate that the defendant must breach an identifiable duty in order to incur criminal or civil liability under rule 10b-5.\(^\text{127}\) He also agreed that Chiarella owed no duty of disclosure to the sellers of target corporation securities.

Stevens wrote a separate opinion in order to stress the fact that had the jury been properly instructed as to Chiarella's liability to his employer and his employer's client, the case might have been decided differently. As to the latter issue, Stevens was noncommittal. He used the broad language of the statute to legitimize the argument that Chiarella's actions may have constituted "a fraud or a deceit" upon the offeror corporation "in connection with the purchase or sale of any security."\(^\text{128}\) Alternatively, he noted that because the offeror corporation was not privy to Chiarella's purchases, that conduct might fall short of being an actionable violation of section 10(b) and rule 10b-5.\(^\text{129}\)

Ultimately, Stevens agreed that reversal was proper for the reason that Chiarella's conviction rested on the erroneous finding that he owed a duty of disclosure to target corporation sellers. This estimation of Powell's analysis points up the fact that the Supreme Court has not necessarily exempted market insiders with access to confidential corporate information from the antifraud provisions of the Exchange Act. Clearly, the Court has not condoned Chiarella's conduct.\(^\text{130}\)

\textit{The Misappropriation Theory}

Justice Brennan concurred with the majority because he would abhor affirming Chiarella's conviction on the basis of a legal theory inadequately explained to the jury.\(^\text{131}\) His concurrence is with Powell's procedural treatment of the case.

Brennan, however, unequivocally rejected the majority's interpretation of the relevant substantive law. He did not agree that a fiduciary relationship between the buyer and the seller is an indispensable element of a rule 10b-5 offense. Rather, he sub-

\(^{127}\) Id. (Stevens, J., concurring).

\(^{128}\) Id. at 1119-20.

\(^{129}\) See Blue Chip Stamps v. Manor Drug Stores, 421 U.S 723 (1975); see also Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.) cert. denied, 343 U.S. 956 (1952). The "purchaser-seller" limitation on private rights of action under rule 10b-5, originated in the Birnbaum decision and was recently reaffirmed in Blue Chip.

\(^{130}\) 445 U.S. at 238.

\(^{131}\) Id. (Brennan, J., concurring).
scribed to a misappropriation theory. According to this view, it is the wrongful conversion of nonpublic information for personal profit which constitutes securities fraud under section 10(b). Although part of the majority in Chiarella, for the purpose of predicting the direction which the Court will follow in future cases which hinge upon an interpretation of 10b-5, Justice Brennan should be associated with the dissent.

Chief Justice Burger's dissent also promoted a misappropriation theory. Burger read section 10(b) to mean, literally, that any person who has misappropriated nonpublic information is subject to the disclose or abstain rule. He believed that repeated use of the word "any" in the statute negates the presumption that the rule applies only to corporate insiders. In Burger's view, the common law limitations upon the duty to disclose are based upon a recognition that an informational advantage obtained as a result of business acumen, experience and skill should not be denied. It is not inconsistent with common law policy to require disclosure where material information is unlawfully acquired.

The Equal Access Theory

The legal theory expressed in Justice Blackmun's dissent is almost parallel to that adopted by the Second Circuit. Blackmun conceded that the Chief Justice's misappropriation theory would successfully incriminate Chiarella under rule 10b-5. In Blackmun's view, however, Chiarella would be guilty of securities fraud even if he had obtained the information with Pandick's consent.

His theory is that the antifraud rules were promulgated to prevent profiteering by anyone who possesses an informational advantage regardless of that individual's fiduciary obligations or the manner in which the information was procured. Blackmun agreed with the court of appeals that it is unequal access to market information which triggers the duty to disclose or abstain under rule 10b-5. He further argued that federal securities laws should be liberally rather than narrowly construed.

The essence of Blackmun's dissent is that the securities laws were not intended to replicate the laws of fiduciary relationships. He insisted that the purpose of the Exchange Act is to ensure fair dealing where the common law does not ade-
quately protect investors and that disparity of access to inside information is the gravamen of a rule 10b-5 offense.

Blackmun noted that strict application of caveat emptor is rapidly being replaced by a less formalistic application of the duty to disclose. Justice Powell, Blackmun urges, has put securities law in the "rear guard" of a movement toward consumer protection.\textsuperscript{137}

**Conclusion**

The blatantly deceptive practices of big business operators in the 1920's prompted codification of the federal securities laws. The objective was to restore investor confidence by eliminating disparities in the availability of information. The health of the economy was at stake as the public shied away from a market in which it was clearly the disadvantaged party.\textsuperscript{138}

Under the Powell approach to rule 10b-5, investors lose that priority. The special relationship test of liability would limit application of rule 10b-5 to transactions between corporate insiders (or their tippees) and shareholders. The buying public would be wholly unprotected from the misuse of special information except, perhaps, as the incidental beneficiary of a shareholder's suit. In fact, adoption of the special relationship requirement casts serious doubt upon the continued vitality of a private right of action for rule 10b-5 violations which occur during the course of an anonymous stock exchange transaction. A plaintiff in such a position would not, ordinarily, be able to identify an insider as the purchaser or seller.

Justice Powell's resistance to the concept of market insider liability is expressed as concern that such a rule would interfere with the valuable stabilizing functions performed by market professionals. The specialists' use of market information, however, is statutorily controlled and patently distinguishable from the type of fraud involved in Chiarella. The unregulated use of confidential information, such as the identity of a tenderor's target, operates to derange market prices. It is only logical to conclude therefore, that a trader should not be permitted to profit from his relationship to the market simply because he has no corresponding duty to the corporate source of the information he receives.

*Chiarella* should not, however, be relied upon to validate the purloining of market information. The majority is more reflective of a reluctance to convict the petitioner in the context of

\textsuperscript{137} Id. at 249.
\textsuperscript{138} See generally note 23 and accompanying text supra.
questionable jury instructions than it is representative of strong support for Powell's legal analysis. Three justices unequivocally joined the Powell majority. Justice Stevens concurred with the legal theory but warned against construing the decision as official approval of Chiarella's conduct. The second concurring opinion disagreed with the majority's interpretation of rule 10b-5, as did the two dissenting opinions. What appears, therefore, to be a majority of six is, upon closer scrutiny, a predictable four votes in support of the view that a Chiarella defendant, afforded a proper trial in all respects, would be acquitted.

Moreover, the SEC, which is vested with broad regulatory authority, gives every indication of exercising that authority in such a way as to inhibit Chiarella type conduct. The Commission has, though in a limited way, already reacted to the Chiarella case. New rule 14(e) (3) is specifically addressed to tender offers and would make it unlawful for one other than the prospective bidder to trade on the basis of nonpublic information relating to a contemplated tender offer.

Chiarella exemplifies the difficulties involved in using rule 10b-5 as the source of a duty of disclosure in cases involving market information. When one considers the definitional problems associated with identifying those individuals who owe a duty of disclosure under rule 10b-5, the holding in Chiarella is viscerally satisfying. Principles of fairness marshall against holding Mr. Chiarella to such an abstract standard of liability. If one believes, however, that the securities laws were designed to protect investors by curbing the use of unfair informational advantages, then no-risk trading by market insiders cannot be justified.

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139. See *In re Dirks*, [1981] Fed. Sec. L. Rep. (CCH) ¶ 82,812 (1981). A securities analyst violated rule 10b-5 by tipping confidential information to a select group of investment advisers. The SEC took the position that finding a professional analyst in violation of insider trading rules would not "chill other analysts from the legitimate and desirable function of seeking out corporate information." *Id.*

See also Lubasch, *5 Charged with Trading on Secret Merger Data*, N.Y. Times, Feb. 4, 1981, at D1-D6, col. 2. Two of the men charged occupied key positions in two of Manhattan's most prominent investment banking firms. These two individuals apparently tipped inside information about corporate takeover plans to three other individuals who used secret foreign bank accounts to buy stock in the target companies. According to the indictment, these purchases yielded enormous profits to the five defendants. The prosecution, still pending, grew out of an extensive investigation initiated by the United States Attorney's Office and the SEC.