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THE AFFIRMATIVE DUTY TO DISCLOSE UNDER RULE 10B-5

I. INTRODUCTION

The linchpin of federal securities law is full disclosure of information in order that investors have the opportunity to make informed investment decisions. An administrative device created to implement this theme is rule 10b-5,[1] promulgated pursuant to section 10(b)[2] of the Securities Exchange Act of 1934.[3] Because section 10(b) is a catchall provision designed to prevent fraudulent activities,[4] the Securities and Exchange Commission (SEC) and the judicial branch have had to delineate the parameters of 10b-5.[5]

Perusal of the generic language of 10b-5[6] reveals that false statements and misleading half-truths, made in the purchase or sale of any security, are clearly prohibited. The unlawful nature of non-disclosure of material nonpublic information, however, is not specifically addressed. The rule simply does not state "whether silence

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1. The rule states:

> 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 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 (1980) [hereinafter cited as 10b-5].

2. Section 10(b) 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 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 (1980).

3. *Id.* §§ 78a-78hh.

4. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 206 (1976).

5. In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975), the case law which has developed under 10b-5 was metaphorically compared to "a judicial oak which has grown from little more than a legislative acorn."

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

may constitute a manipulative or deceptive device."[7] Unlike active misrepresentation, failure to disclose material nonpublic information, prior to trading securities, amounts to fraud only when the silence is in breach of an affirmative duty to disclose.[8] The duty to disclose, established by administrative and judicial decisions, has devolved upon corporate insiders,[9] the tippee of an insider,[10] and one standing in a special relationship with the purchaser or seller of the security.[11] Absent one of these essential relationships, with the corporation affected by the information or with the injured party, the case unanimously hold that there is no duty to disclose.[12]

Recently, an alternative theory was proffered, extending the duty to disclose to the market insider, a person who regularly receives material nonpublic information.[12] Although the United States Supreme Court, in *United States v. Chiarella*,[14] expressly rejected this

7. Chiarella v. United States, 100 S. Ct. 1108, 1113 (1980).

8. Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275, 282 (2d Cir. 1975); Kohler v. Kohler, 319 F.2d 634, 637-38 (7th Cir. 1963). *See* 3 L. Loss, SECURITIES REGULATION, Chapter 9C (1961)[hereinafter cited as 3 *Loss*].

9. An "insider" is anyone whose relationship to a corporation gives them "access, directly or indirectly, to information intended to be available only for a corporate purpose." In re Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961). *See* notes 64-95 and accompanying text *infra*.

10. The term "tippee" seems to have first been denominated by Professor Loss. 6 L. Loss, SECURITIES REGULATION 3561 (1961)[hereinafter cited as 6 *Loss*]. A "tippee" is someone with no relation to the company who receives inside information from an insider and "knew or had reason to know" that the information was nonpublic. In re Investors Management Co., 44 S.E.C. 633, 641 (1971). Some courts and commentators have not used the tippee terminology, because, they argue, tippees are insiders, even though they have no position in the corporate hierarchy. *See, e.g.*, Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967). The difficulty is merely one of judicial semantics, since rule 10b-5 is capable of being applicable to "any person." 17 C.F.R. § 240.10b-5 (1980). Rapp & Loeb, *Tippee Liability and Rule 10b-5*, U. ILL. L.F. 55, 55 (1976). *See* notes 96-128 and accompanying text *infra*.

11. One who occupies a position of trust and confidence with a trading party, typically a fiduciary relationship, has a duty to disclose because of that relationship. *See* notes 129-134 and accompanying text *infra*.

12. S.E.C. v. Great Am. Indus. Inc., 407 F.2d 453, 460 (2d Cir. 1968) (*en banc*), *cert. denied*, 395 U.S. 920 (1969); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); Kohler v. Kohler, 319 F.2d 634 (7th Cir. 1963). *See* Fleischer, Mundheim & Murphy, *An Initial Inquiry Into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 804 (1973)[hereinafter cited as Fleischer]; 1 A. BROMBERG, SECURITIES LAW: FRAUD § 741(6)(b), at 179-83 (1977)[hereinafter cited as BROMBERG].

13. "Market information" is information about events which affect the marketability of a corporation's securities without affecting the corporation's assets or earning power. Fleischer, *supra* note 12, at 799. Whereas "inside information" has been defined as nonpublic facts relating to the issuer's business or which are usually intended to be available only for a corporate purpose. *See generally* 5 A. JACOBS, THE IMPACT OF RULE 10b-5 § 66.62(b) (rev. ed. 1978).

14. 100 S. Ct. 1108 (1980).

novel concept, it is useful, analytically, in examing the scope of the duty to disclose under 10b-5.

II. THE DEVELOPMENT OF LIABILITY FOR NONDISCLOSURE

A. *The Duty to Disclose Under the Common Law*

At common law, a party to a securities transaction was protected from material misrepresentations, made to induce reliance upon the false statement, which resulted in his detriment. Oftentimes, an action for fraud would not lie, however, for mere nondisclosure.[15] No remedy was available for damages sustained as a consequence of the other party's silence, unless there was an affirmative duty of disclosure.[16] The imposition of a duty to disclose was generally triggered by a fiduciary or other relation of trust and confidence between the parties.[17]

The most common situation in which the question of a duty had been litigated involved security transactions between directors of the corporation and individual stockholders. Where the director actively misled the shareholder or made false misrepresentations, the case was decided without reference to the nature of the relation between them.[18] More frequently, a director would have knowledge affecting the value of stock, gained in his official capacity with the corporation and merely remain silent about the information in the transaction with the stockholder. Assuming the director refrained from affirmatively misrepresenting information acquired through his position as an insider he could usually trade in shares of his corporation with impunity.[19] Thus, in the absence of a duty to disclose, the failure of the director to disclose facts pertaining to corporate affairs was not actionable. Although a director had a fiduciary relationship to the corporation and to the stockholders collectively in his management of the

15. *See, e.g.*, Boileau v. Records & Breen, 165 Iowa 134, 144 N.W. 336 (1913); Windram Mfg. Co. v. Boston Blacking Co., 239 Mass. 123, 131 N.E. 454 (1921).

16. Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910 (1969). The American Law Institute has declared that "silence when there is a duty to speak may be a fraudulent act." ALI, *Federal Securities Code* § 262(b) (Proposed Official Draft 1978).

17. *See* W. PROSSER, LAW OF TORTS § 106 at 697 (4th ed. 1971) and cases cited therein. *See also* RESTATEMENT OF TORTS, § 551 (1938).

18. The ordinary rules of fraud would apply when a misrepresentation was made by a director to a shareholder. Traer v. Clews, 115 U.S. 528 (1885); Morrison v. Snow, 26 Utah 247, 72 P. 924 (1903). Note, *Corporations—Directors—Relation of Director to Individual Stockholder From Whom He Purchases Shares of the Corporation*, 14 MINN. L. REV. 530, 531 (1930).

19. Carpenter v. Danford, 52 Barb. 581 (N.Y. 1868).

corporation,[20] the courts were divided on the nature of the relation between a director and individual stockholders.

Under the common law majority view, which has been described as the "strict rule," no fiduciary relationship existed between a director and individual stockholders; hence, the insider had not duty to disclose information pertaining to corporate affairs.[21] A director could deal with a stockholder as freely as he might with a stranger without being accountable for withholding information which affected the value of the stock.[22] The rationale of this view is that because of the interposition of the corporate entity, the director did not occupy a position of trust in relation to the various holdings of individual stockholders.[23] The stock was regarded as the personal property of each stockholder over which the director had no control.[24] The nonrecognition of a fiduciary duty to the shareholder permitted directors,[25] officers,[26] and persons who occupied both positions[27] to trade securities without explication.[28]

The minority view was that a fiduciary relationship existed between a director and individual shareholders, with the consequent imposition of a duty to disclose. by disregarding the fictional corporate entity some courts deemed a director to be not only a trustee for the corporation, but also as a trustee for individual stockholders.[29] Some critics have theorized that information regarding the value of shares, which a director acquires by virtue of his corporate position, is a quasi-asset of the corporation held in trust for the benefit of individual

20. *E.g.*, Conolly v. Shannon, 105 N.J. Eq. 155, 147 A. 234 (1929), *aff'd per curiam*, 107 N.J. 180, 151 A. 905 (1930); Seitz v. Frey, 152 Minn. 170, 188 N.W. 266 (1922). *See* 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 838 at 142 (Perm. ed. 1975).

21. Fox v. Cosgriff, 66 Idaho 371, 381, 159 P.2d 224, 228 (1945) (dictum); Goodwin v. Agassiz, 283 Mass. 358, 361-62, 186 N.E. 659, 660 (1933); Seitz v. Frey, 152 Minn. 170, 174, 188 N.W. 266, 268 (1922).

22. DuPont v. DuPont, 242 F. 98, 136 (D.C. Del 1917), *cert. denied*, 250 U.S. 642 (1918); Hooker v. Midland Steel Co., 215 Ill. 444, 456, 74 N.E. 445, 447 (1905).

23. Bigelow, *The Relation of Director of a Corporation to Individual Stockholders*, 81 CENT. L.J. 256, 261 (1915).

24. Hooker v. Midland Steel Co., 215 Ill. 444, 74 N.E. 445 (1905).

25. *E.g.*, Walsh v. Goulden, 130 Mich. 531, 90 N.W. 406 (1902); Carpenter v. Danforth, 52 Barb. 581 (N.Y. 1868).

26. *E.g.*, Seitz v. Frey, 152 Minn. 170, 188 N.W. 266 (1922).

27. *E.g.*, Connolly v. Shannon, 105 N.J. Eq. 155, 147 A. 234 (1929), *aff'd per curiam*, 107 N.J. Eq. 180, 151 A. 905 (1930).

28. Note, *Civil Liabilities Under Rule X-10b-5*, 42 VA. L. REV. 537, 548 (1956)[hereinafter cited as *Civil Liabilities*].

29. Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903); Dawson v. National Life Ins. Co., 176 Iowa 362, 157 N.W. 929 (1916).

stockholders.[30] Conceding that corporate information may be a quasi-asset of the corporation, it must be concluded that because of the separate legal status of a corporation and its owners and agents the director's agency status exists only to the aggregate body of stockholders.[31] The confidence placed by the stockholders in the director relates to the management of the corporate business and not the separate affairs of each stockholder.[32] The stockholder's right to redress a director's wrong against the corporation, which incidentally affects the value of corporate assets, is only derivative.[33] The stockholder suffers, if at all, vicariously through the corporation. When the activities of the director affect the assets of the corporation, and concomitantly the value of the stockholder's shares, all stockholders suffer.[34] The director's conduct in trading shares of the corporation without disclosure of nonpublic information, however, does not directly affect the assets of the corporation. In this instance, the shareholder with whom the director has traded, and not the corporation, is the proper party to complain.[35]

The ordinary principles of fiduciary duty are, therefore, not applicable to the relationship of a director and individual stockholders, and without the imposition of this duty the director is not required to assume the responsibilities of a trustee.[36] The relation of director-shareholder simply does not fit neatly into any of the traditional fiduciary categories. Nevertheless, this fiduciary duty has been found

30. *See supra* note 18, at 535 and cases cited therein at footnote 30.

31. *See* note 20 and accompanying text *supra*.

32. Laylin, *The Duty of a Director Purchasing Shares of Stock*, 27 YALE L.J. 731, 734 (1918).

33. Board of Comm'n of Tippecanoe County v. Reynolds, 44 Ind. 509 (1893).

34. *See supra* note 32, at 733.

35. *Id.*

36. The court in *Oliver v. Oliver*, 118 Ga. 362, 45 S.E. 232 (1903), conceded that because of the separate legal status of a corporation, a director's relationship to individual shareholders is not that of a trustee in the usual sense of the word. In justifying the imposition of a duty to disclose, the court stated:

> All the authorities agree that he (the director) is trustee for the company, and in his capacity as such he serves the interests of the Entire body of stockholders, as well as those of the individual shareholders, who usually cannot sue in his own name for wrongs done the company by the officer. But the fact that he is trustee for all is not to be perverted into holding that he is under no obligation to each. . . [N]o process of reasoning and no amount of argument can destroy the fact that the director is, in a most important and legitimate sense, trustee for the stockholder. Not a strict trustee, since he does not hold title to the shares, not even a strict trustee who is practically prohibited from dealing with his *cestui que* trust, but a quasi trustee as to the shareholders interest in the shares.

Id. at 367, 45 S.E. at 233-34. *See* Dawson v. National Life Ins. Co., 176 Iowa 362, 379, 157 N.W. 929, 934 (1916).

to exist.[37] The endeavor by those courts to enlarge the law governing fiduciaries so as to include the director-shareholder relationship appears to be precipitated by practical and moral prejudices.[38] The desirability of finding a fiduciary relation is bottomed on the moral inequities that would result from the director, by virtue of his unequal bargaining position, being able to take advantage of stockholders.[39]

To avoid the severity of the majority view some courts adopted an intermediate position, by application of the "special facts" doctrine enunciated in the seminal case of *Strong v. Repide*.[40] In *Strong*, the defendant, as director, controlling shareholder, and officer of a corporation, acted as chief negotiator for the sale of the corporation's land at a price which would greatly enhance the value of the shares. The defendant concealed his identity as a purchaser of the plaintiff's shares through a broker, and obtained the shares for a price substantially less than they were worth. The Court held that because of the insider's special knowledge under the circumstances "it became the duty of the defendant, acting in good faith, to state the facts before making the purchase."[41]

The "special facts" doctrine neither supports nor repudiates the majority rule that a director owes no affirmative fiduciary duty of

37. This view has met the approval of numerous legal commentators. *See* Laylen, *The Duty of a Director Purchasing Shares of Stock*, 27 YALE L.J. 731 (1918); Smith, *Purchase of Shares of a Corporation by a Director from a Shareholder*, 19 MICH. L. REV. 698 (1921); Wilgus, *Purchase of Shares of Corporations by a Director from a Shareholder*, 8 MICH. L. REV. 267 (1910).

38. In *Oliver v. Oliver*, 118 Ga. 362, 45 S.E. 232 (1903), the court said that to permit a director to take advantage of his position "would offer a premium for faithless silence, and give a reward for the suppression of truth." *Id.* at 370, 45 S.E. at 235.

39. In finding a fiduciary duty the court in *Dawson v. National Life Ins., Co.*, 176 Iowa 362, 157 N.W. 929 (1916), considered the injustice in permitting a director to take advantage of his official position.

> The debate as to whether technically a fiduciary relation exists may and doubtless will go on, but a knowledge of the law is not required to appreciate the moral wrong perpetrated by a corporate officer with knowledge acquired by virtue of his position in profiting on the ignorance of a stockholder.

Id. at 375-76, 157 N.W. at 933. *See* Wilgus, *supra* note 37, at 267.

40. 213 U.S. 419 (1909).

41. *Id.* at 431. 3 *Loss*, *supra* note 8, at 1447. The court took cognizance of the "strict rule," noting that because of the "special circumstances" the director had a duty to disclose.

> If it were conceded, for the purpose of 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.

213 U.S. at 431.

disclosure to the stockholders with whom he trades.[42] Rather, the doctrine is an attempt to disparage the harshness of the majority view by finding exceptions which will give rise to a fiduciary duty in special circumstances.[43] Manifestly, the "special facts" doctrine is premised on a relationship between director and shareholder which is different from the relationship between arms-length traders.[44] The director-stockholder relationship in *Strong* was a necessary requisite for finding the special circumstances, namely, that the defendant had been entrusted with the negotiations to sell the corporation's assets. Had the defendant not been a director there would not have been a fiduciary relation with the trading stockholder.[45] The Court, however, took great pains to emphasize that the defendant's position as a director was only one of the facts which was considered.[46]

The "special facts" doctrine, thus, imposes a duty to disclose under exceptional circumstances when the corporate insider possesses peculiar knowledge enhancing the value of the stock.[47] The courts which have applied the doctrine admit that there is no fiduciary relation between a director and individual stockholders with respect to the trading of stock in a corporation. Essentially, a director with superior knowledge of corporate affairs stands in a special relation to a stockholder. Outstanding corporate facts which have implicated the "special facts" doctrine include the director's undisclosed knowledge concerning a prospective corporate reorganization,[48] probable liquidation of the corporation,[49] sales of large blocks of assets,[50] and impending declarations of unusual dividends.[51] The doctrine, which remains basically ill-defined,[52] has been an impediment to directors who have attempted to take advantage of a stockholder's ignorance.

42. Note, *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)[hereinafter cited as *A New Concept*].

43. H. BALLENTINE, CORPORATIONS 213 (rev. ed. 1946)[hereinafter cited as BALLENTINE].

44. 3 *Loss supra* note 8, at 1447. *See* Petter v. Litton, 308 U.S. 295 (1939).

45. 3 *Loss supra* note 8, at 1447.

46. 213 U.S. at 431.

47. Those special circumstances producing exceptional cases were enumerated in *Buckley v. Buckley*, 230 Mich. 504, 508, 202 N.W. 955, 956 (1925), as "an assured sale, merger, or other fact or condition enhancing the value of the stock, known by the officer or officers, not known by the shareholder, and not to be ascertained by an inspection of the books."

48. *E.g.*, Nichol v. Sensenbrenner, 220 Wis. 165, 263 N.W. 650 (1935).

49. *E.g.*, Fox v. Cosgriff, 66 Idaho 371, 159 P.2d 224 (1945).

50. *E.g.*, Bollstron v. Duplex Power Car Co., 167 Minn. 171, 208 N.W. 650 (1935).

51. *E.g.*, Lesnik v. Public Indus. Corp., 144 F.2d 968 (2d Cir. 1944).

52. *Supra* note 18, at 534.

Those courts which have acknowledged the existence of a director's duty of disclosure have been reluctant to extend that duty where the director has traded listed securities through the medium of a stock exchange.[53] Typically, the trading of stock on a stock exchange is impersonal, because of the anonymity separating buyer and seller.[54] As a practical matter, the machinery of the stock exchange does not permit the director to make a personal disclosure to the other party of the transaction.[55] The courts which have expressed disfavor with the potential for unethical conduct on an impersonal exchange have simply been hindered by the rigid requirements of the common law remedies.[56]

B. Duty of Disclosure Under Rule X-10-5

The inadequacies of the common law remedies coupled with the multifarious interpretations of its nondisclosure rules, prompted enactment of section 10(b) of the Securities Exchange Act and rule 10b-5. These anti-fraud provisions provide a broad framework within which the courts and the SEC may promote an honest and fair securities market to protect public investors.[57] The lawfulness of complete nondisclosure is not covered by the language of 10b-5.[58] The prohibition of clauses (a) and (c) of 10b-5 are couched in terms of fraud without any reference that failure to provide material nonpublic information might run afoul of section 10(b).[59] Clause (b) prohibits affirmative misrepresentations which are half-truths, but does not, by its language, require one to speak in the first instance.[60] The failure to disclose a material fact is only fraudulent when it is necessary to make other

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53. In *Goodwin v. Agassiz*, 283 Mass. 358, 363, 186 N.E. 659, 661 (1933), the court adopted the "special facts" doctrine, but refused to impose a duty of disclosure where the shares were purchased on a stock exchange.

54. BALLENTINE, *supra* note 43, at 215.

55. In *Goodwin v. Agassiz*, 283 Mass. 358, 363, 186 N.E. 659, 661 (1933), the court stated:

> [a]n honest director would be in a difficult situation if he could neither buy nor sell on the stock exchange shares of stock in his corporation without first seeking out the other actual ultimate party to the transaction and disclosing to him everything which a court or jury might later find that he knew affecting the real or speculative value of such shares. Business of that nature is to be governed by practical rules.

56. *A New Concept*, *supra* note 42, at 564.

57. It has been contended that the term fraud as used in the Act was not limited to common law concepts, but was intended to include "all deceitful practices contrary to 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)).

58. *A New Concept*, *supra* note 42, at 565.

59. *See* note 1 *supra*.

60. *See SEC Release No*. 3230 (May 21, 1942).

statements made not misleading.[61] The legislative history of section 10(b) is equally unrevealing in that it fails to indicate a congressional intent to include within its ambit trading without disclosure.[62] Consequently, the law initially governing the duty to disclose under 10b-5 was the same as the various common law views declared by the state courts.[63]

1. Insiders.

State law gradually supplanted by a new body of federal corporation law as a result of the Securities Exchange Act,[64] and more specifically 10b-5. This federal law was given substance with respect to the application of 10b-5 to the nondisclosure of material nonpublic information in *Cady, Roberts & Co.*[65] In *Cady, Roberts*, the SEC brought a disciplinary action under 10b-5 against a broker of Cady, Roberts & Co., a broker-dealer firm, who received information about a proposed cut in the dividends of Curtiss-Wright Corporation. The information was received from one of the brokerage firm's partners, who was also a director of Cutiss-Wright Corporation. Knowing that the information had not reached the exchange and been publicly released, the broker executed two sell orders: one to sell shares of Curtiss-Wright stock, and the other to sell short in the stock.[66] The

61. Note 1 *supra*, clause (b).

62. *See* S. REP. NO. 792, 73d *Cong.*, 2d *Sess.* 18 (1934); H.R. REP. NO. 1838, 73d *Cong.*, 2d *Sess.* 32 (1934).

63. For the discussion of the various common law views *see* notes 21-52 and accompanying text *supra*. In *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947), the first case permitting recovery under rule 10b-5, the court stated that if the duty to disclose was found in general equitable principles if would fall under the statute. The court found the defendant's conduct to come within the proscriptions of the act by holding that "the broad terms of the Act are to be made effective in a case like the present one through application of well known and well established equitable principles governing fiduciary relationships." *Id.* at 803. This statement seems to indicate that the substantive law in Pennsylvania, which followed the so-called minority view requiring disclosure, was applied in determining whether civil relief under rule 10b-5 was to be granted. At no time did the court intimate that the duty under rule 10b-5 was greater than the common law duty to disclose. *See Civil Liabilities, supra* note 28, at 556-57. *See also* Speed v. Transamerica Corp., 99 F. Supp. 908 (D. Del. 1951).

64. Despite the decline in importance of a "Federal rule" as a result of *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938), the securities acts, which expressed an interest which had hitherto been exclusively the concern of the states, generated a new and far-reaching body of federal substantive corporation law. In re Cady, Roberts & Co., 40 S.E.C. 907, 910 (1961). *See* McClure v. Borne Chemical Co., 292 F.2d 824, 834 (3rd Cir. 1961).

65. 40 S.E.C. 907 (1961).

66. A seller who sells short in stock agrees, at the present market price, to deliver the shares by some future date with the expectation that the price will drop before he has to deliver them. S. HUEBNER, THE STOCK MARKET, 40-42 (1st ed. 1922).

SEC held that the broker's failure to disclose the nonpublic information regarding Curtiss-Wright's dividend action violated rule 10b-5.

Since the purchasers were not shareholders of Curtiss-Wright before consummation of the sales, the effect of *Cady, Roberts* is to expand the common law duty of disclosure to include sales of securities made to non-stockholders.[67] The fulcrum of *Cady, Roberts* is that the remedial anti-fraud concepts embodied in 10b-5 are to be effectuated by rejecting the distinction existing at common law that an officer or director may stand in a fiduciary relationship to stockholders with whom he trades,[68] but not to members of the public.[69] The duty to disclose emanates from "the existence of a relationship giving access . . . to [corporate] information . . . and the inherent unfairness involved where a party takes advantage of such information."[70] The insider's duty is regarded primarily in terms of access to nonpublic information, and not solely in terms of a fiduciary duty based on trust and confidence. Emphasis is placed on identifying those persons who are in a special relationship with the corporation, giving access to inside information.[71] Persons who are privy to a company's internal affairs must suffer the correlative duties in trading in its securities.[72]

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67. Chairman Cary, speaking for the Securities and Exchange Commission, rejected the selling broker's contention that "an insider's responsibility is limited to existing stockholders and . . . he has no special duties when sales of securities are made to non-stockholders." 40 S.E.C. 907, 913. It was further stated that "this approach is too narrow . . . because [i]t ignores the plight of the buying public-wholly unprotected from the misuse of special information." *Id.*

68. Under the common law "strict rule" there was no fiduciary relationship even between a director and individual stockholders. *See* notes 21-28 and accompanying text *supra.*

69. The Commission stressed that

> [W]hatever distinctions may have existed at common law based on the view that an officer or director may stand in a fiduciary relationship to existing stockholders from whom he purchases but not to members of the public to whom he sells, it is clearly not appropriate to introduce these into the broader anti-fraud concepts embodied in the securities acts.

40 S.E.C. at 913-14.

70. *Id.* at 912. The quoted material has been referred to as the "access test." This test is used to determine whether a duty to disclose is required under rule 10b-5, and states in its entirety, as follows:

> Analytically, the obligation [to disclose] 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.

Id. (footnotes omitted).

71. *Id.*

72. *Id.* "Intimacy demands restraint lest the uninformed be exploited." *Id.*

Paradoxically, the broker in *Cady, Roberts* did not occupy any corporate position within Curtiss-Wright Corporation. The SEC, however, refused to restrict application of 10b-5 to traditional insiders as defined by section 16 of the Exchange Act.[73] Because the broker had "access" to nonpublic information through a director or other insider, he was subject to rule 10b-5 notwithstanding the absence of any relationship with the affected corporation.

The *Cady, Roberts* analysis for implying a duty to disclose has served as the touchstone for subsequent judicial and adminstrative decisions.[74] This belief was expressed by the United States Court of Appeals for the Second Circuit in *S.E.C. v. Texas Gulf Sulphur*,[75] by describing the *Cady, Roberts* analysis as the "essence" of rule 10b-5.[76] In *Texas Gulf*, the SEC sought to enjoin and compel recission of security transactions involving Texas Gulf Sulphur stock entered into by several of its directors, officers, and employees. The *Texas Gulf* court held that the defendants had contravened section 10(b) and rule 10b-5 by purchasing the stock of Texas Gulf without disclosure of nonpublic information.[77] In addition to an exposition of the *Cady, Roberts* access delineation of insider, a broader definition of insider was expounded to include "anyone in *possession* of material inside information."[78] This expanded definition of "insider" was construed to bring within its purview not only the directors and management of-

73. Section 16(a) of the 1934 Act defines a corporate insider as "[e]very person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity securities . . . or who is a director or an officer of the issuer of such security." 15 U.S.C. § 78p(a) (1976). The purpose of § 16(b) is to prevent the unfair use of nonpublic information by requiring an insider to disgorge any profits "realized by him from any purchase and sale, or any sale and purchase . . . [of the issuer's securities] within any period of less than six months." *Id.* § 78p(b).

74. *See* Fleischer, *supra* note 12, at 805.

75. 401 F. 2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

76. 401 F.2d at 848.

77. The inside information concerned the discovery and exploration of an extraordinary ore anamoly. Texas Gulf was charged with issuing a deceptive press release designed to quell the rumors of the mineral discovery three days prior to the official announcement. The effect of the statement announcing the discovery was so devastating that the price of Texas Gulf stock rose from an opening price of 30 1/8 on the day of its announcement to 58 1/4 approximately one month later. *Id.* at 847.

78. *See* Sandler & Conwill, *Texas Gulf Sulphur; Reform In The Securities Marketplace*, 30 OHIO ST. L.J. 225, 241 (1969) (emphasis added)[hereinafter cited as Sandler & Conwill]. Immediately after citing *Cady, Roberts*, the *Texas Gulf* court defined the duties of an insider: "[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, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed." 401 F.2d at 848.

ficers of Texas Gulf, but also its employees.[79] According to *Texas Gulf*, any person who gains possession of information as a result of general accessibility to inside information by virtue of a corporate position is classified as an insider. Once classifed as an insider the party must, before trading, disclose the information to the public or abstain from trading in the securities while the inside information remains undisclosed.[80]

In imposing the duty to disclose *Texas Gulf* drew no distinction between employees with positions of varying responsibilities.[81] Under *Texas Gulf*, therefore, lower echelon employees who become privy to inside information through their relationship with the corporation will fall within the group of insiders.[82] The degree of the employees' involvement in corporate affairs should not be relevant since uninformed investors are equally disadvantaged *vis-a-vis* lower echelon agents as they would be with respect to a corporate director, except to the extent that the higher level employees might at least superfically have more reliable inside information.[83]

A vexing problem with the possession test of *Texas Gulf* is that the court does not explicitly discuss the requirement of a relationship with the affected corporation.[84] Application of the possession test, without that relationship, could conceivably impose liability on a person who inadvertantly overhears a private conversation, even though he has no relationship to the corporation.[85] Since *Texas Gulf* adopts the access test of *Cady, Roberts*, by implication, a relationship to the affected corporation is required.[86] Read together, *Texas Gulf* and *Cady,*

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79. The employees named as defendants for violating 10b-5 included a geophysicist, a geologist, an accountant, and an office manager.

80. *Id.*

81. The defendants in *Texas Gulf* possessed a modicum of responsibility within the corporate hierarchy, though some were technically lower echelon employees. It follows that a strict interpretation of the decision requires the standards adopted by the court to be limited to those types of employees and not viewed as binding upon all types of corporate employees.

82. It seems as if the information need only be obtained "in the course" of the insiders employment and would include a secretary who learns of material information while taking dictation, or a janitor who finds such information in a wastepaper basket. *See* Jennings, *Insider Trading in Corporate Securities: A Survey of Hazards And Disclosure Obligations Under Rule 10b-5*, 62 NW. U. L. REV. 809, 827, n.82 (1968) and cases cited therein.

83. Sandler & Conwill, *supra* note 78, at 240.

84. 401 F.2d at 848.

85. It has been claimed that the access test of *Cady, Roberts* could impose liability on a person under the same circumstances. Ruder, *Texas Gulf Sulphur-The Second Round: Privity And State Of Mind In Rule 10b-5 Purchase And Sale Cases*, 63 N.W. U. L. REV. 423, 439 (1968). This proposition may be dismissed as specious since the access test specifically requires the existence of a relationship to the corporation.

86. 401 F.2d at 848.

Roberts, require a duty to disclose when it is demonstrated that a nexus exists between the insider and the corporation.[87] For rule 10b-5 to be applicable, the undisclosed information that forms this nexus must originate from the affected corporation. An obligation to disclose may also be implied from a fiduciary relationship between the trading parties, but the absence of a relationship founded on trust and confidence will no longer be dispositive. More often, the proper inquiry will be whether the person trading in the shares is an insider. For example, in *General Time Corp. v. Talley Industries, Inc.*,[88] Talley Industries attempted to displace the management of General Time. General Time claimed that rule 10b-5 had been violated because Talley Industries had acquired stock of General Time without disclosing its plan for a merger "whose terms might be more favorable than the price paid for the stock being acquired."[89] Talley Industries did not utilize information of and had no fiduciary relation with General Time. The United States Court of Appeals for the Second Circuit held that a purchaser of stock had no duty to disclose his knowledge of future prospects unless he holds a fiduciary position with the seller or has obtained his knowledge by virtue of an insider position,[90] neither of which was satisfied in *General Time*.[91] Insider status is not established merely because there is an awareness of circumstances indicating that there may be a profit-making opportunity in purchasing all or a controlling block of a company's shares.[92] The tender offeror in *General Time* was not required to disclose its intentions of a future tender offer before purchasing the stock of General Time, the target company, on the open market.[93] Talley Industries, the offeror, may well have been

87. *See* Note, *Rule 10b-5; Scope of Liability Extended as Former Outsiders Become Market Insiders*, 58 NEB. L. REV. 866, 879 (1979).

88. 403 F.2d 159 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969).

89. 403 F.2d at 164.

90. In *General Time* Judge Friendly said: "We know of no rule of law, applicable at the time, that a purchaser of stock, who was not an 'insider' and had no fiduciary relation to a prospective seller, and any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale." *Id.*

91. Mills v. Sarjem Corp., 133 F. Supp. 753, 764-65 (D. N.J. 1955). *See* 3 *Loss*, *supra* note 8, at 1451-52.

92. Congress, through enactment of the Williams Act, 15 U.S.C. § 78n(d)(1) (1976), has declared that purchases of target stock by a tender offeror before public announcement of the offer are not fraudulent. The Williams Act delimits but does not categorically prohibit such purchases. The purpose of the Act is to require tender offerors and prospective offerors to disclose information that will insure that public shareholders may respond to a cash tender offer with adequate information. Cooperweld Corp. v. Imetal, 403 F. Supp. 579, 594 (W.D. Pa. 1975) (citing Rondeau v. Mosinee Paper Corp., 422 U.S. 49, 58 (1975)).

93. *See* Fleischer, *supra* note 12, at 809-10. Jacobsen Mfr. Co. v. Sterling Precision Corp., 282 F. Supp. 598, 603 (E.D. Wis. 1968); Gulf & Western Indus. Inc. v. Great Atl. & Pac. Tea Co., 356 F. Supp. 1066 (S.D. N.Y.), *aff'd on other grounds*,

acting on nonpublic information, but there was no duty of disclosure because the information was created by itself and did ***not emanate from the target company.***[94] The information was not obtained in the capacity of an insider who, because of a relationship to the target company, had access to the inside information.[95]

While there has been a gradual expansion of insider liability, initiated in the case of *Cady, Roberts,* the one constant which permeates all subsequent cases is the need to show that the alleged violator had some connection with the affected corporation.

2. Tippees

The proscriptions of rule 10b-5 have not been limited to the widespread practice of insider trading. Tippees are also subject to the rule. A tippee[96] generally trades on information that is not available to the public, which is disseminated to him by an insider. Whether the tippee or an insider trades on undisclosed information, the injury to the investing public is essentially the same. The need to bring tippees within rule 10b-5 was recognized as early as *Cady, Roberts.*[97]

Not until *Investors Management Co.*,[98] however, were tippees held civilly liable for trading on material nonpublic information.[99] Under *Investors Management*, tippees violate 10b-5 when they improperly obtain nonpublic information by selective revelation from a corporate

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476 F.2d 687 (2d Cir. 1973). The legality of a prospective offeror's purchase of up to five percent of a target company's stock is not otherwise affected by the Williams Act. Only after five percent of the target company's stock is required is disclosure required. *See* 15 U.S.C. § 78(d)(5).

94. A. BROMBERG, SECURITIES LAW: FRAUD § 6.3(622) (1969) (emphasis added).

95. [W]hile the prospective offeror's intention to make a tender offer may be both material and nonpublic, it is information which relates to the plans of the offeror rather than the affairs of the target company. Accordingly, the prospective offeror should have no fiduciary duty under . . . Rule 10b-5 to reveal its plans to purchase additional shares despite the fact that disclosure of such information would obviously affect the decision of sellers to dispose of their shares at the then current market price (footnotes omitted).

E. ARANOW, H. EINHORN & G. BERLSTEIN, DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL 24 (1973).

96. *See* note 10 *supra.*

97. In a strict sense the broker-dealer in *Cady, Roberts* was a tippee of the insider-director, but was treated as an insider and held liable on that basis.

98. 44 S.E.C. 633 (1971).

99. *Investors Management* involved the proposed sale of McDonnell Douglas convertible debentures for which Merrill Lynch acted as the underwriter. Information was received by Merrill Lynch about a sharp reduction of earnings forecasts for McDonnell Douglas. This information was then passed from Merrill Lynch salesman to various institutional investors who promptly sold a large portion of their McDonnell Douglas stock holdings before the information became public.

source and know or have reason to know of the nonpublic character of the information.[100] The SEC specifically rejected the requirement that the recipient occupy a special relationship to the corporation, or, in the absence of a relationship, that he have actual knowledge that the information was disclosed in breach of a fiduciary duty not to reveal the information.[101] Conceptually, *Investors Management* would require disclosure by a person such as the taxi cab driver, the barber, or the caddy who fortutiously overhears a piece of corporate news, with knowledge of its corporate source.[102] Even though trading on this inside information could have a deleterious effect on the investing public, none of these individuals have any relationship to the corporation. According to *Investors Management*, these "tippees" would nevertheless have a duty to disclose because they are aware of the illicit nature of the information and therey obtain a superior trading position in relation to other investors.[103] In a concurring opinion, Commissioner Smith sought to emphasize that the prohibitions of 10b-5 should focus on the conduct of insiders and their tippees, rather than on a concept of relative informational advantage.[104] What the Commissioner found controlling was the nexus of a special relationship between the tipper and the issuer and the tippee's knowledge of that relationship.[105] In order to be liable, therefore, the tippee must know or have reason to know that he acquired nonpublic information in breach of the tipper's fiduciary duty to maintain confidentiality.[106] The tippee's knowledge would render him a participant in the breach when he acts on the basis of that information.[107]

100. 44 S.E.C. at 641.

101. *Id.* at 643.

102. Ironically, a member of the SEC stated in 1965 that these types of individuals should not be contemplated as being named as defendants in civil actions by the Commission under 10b-5. Budge, *The Texas Gulf Sulphur Case-What It Is And What It Isn't*, CORP. SECRETARY NO. 127 (1965); *See* 6 *Loss*, *supra* note 10, at 3564.

103. 44 S.E.C. at 644.

104. *Id.* at 648. Commissioner Smith stressed the importance of policing insiders and what they do instead of policing information *per se* and its possession. *Id.*

105. "The nexus of the special relationship between Merrill Lynch and [McDonnell] Douglas and [the tippee's] knowledge of that relationship as the source of the information [was] essential to [the] case." *Id.*

106. *Id.* A tippee who has knowledge of the breach in trust would be liable to the same extent as an insider by application of the doctrine in the law of restitution: "Where a fiduciary in violation of his duty to the beneficiary communicated confidential information to a third person, the third person, if he had notice of the violation of duty, holds upon a constructive trust for the beneficiary any profit which he makes through use of such information." RESTATEMENT OF RESTITUTION § 201(2). See 3 *Loss, supra* note 8, at 1451.

107. 44 S.E.C. at 650.

Commissioner Smith's more restrictive definition of tippee comports more with a relationship requirement than the majority's test of "mere possession" with knowledge of the source of the information.[108] A tippee who acts with knowledge of the breach of a fiduciary duty acts with a greater degree of culpability than a tippee who acquires information only knowing that it is of a nonpublic nature.[109] The greater the degree of the tippee's culpability the less attenuated his relationship with the corporation. As a matter of fairness, it is essential that a test be formulated that will ferret out culpable tippees and not hold tippees liable when they had no reason to suspect the blameworthiness of their conduct.[110] Liability where the recipient of the information is unaware of a fiduciary obligation may "penalize or thwart the quest for new knowledge by investors."[111] A vigilant tippee who suspects an allegedly improper source may have to forego a transaction that had the prospect of being a profitable investment.[112] Application of the standard espoused in *Investors Management*—possession and actual or constructive knowledge of its corporate source—might cause investors who indirectly receive inside information[113] to be reluctant in trading on that information.

The untoward nature of the *Investors Management* standard is intensified by the spector of tippee liability when a tippee has only constructive knowledge that the information was acquired from a corporate source. Actual knowledge should be a prerequisite for the line of demarcation of tippee liability.[114] Logically, a tippee needs actual

108. *See* Barnett, *Neither A Tipper Nor A Tippee Be*, 8 HOUS. L. REV. 278, 286 (1970), wherein the author voices approval of a relationship requirement as opposed to a test of "mere possession."

109. Aside from the need for distinguishing between kinds of tippees a differentiation should exist between an insider and a tippee. An insider would have a degree of knowledge which makes his culpability more closely approach that of a tippee who is aware of a breach of fiduciary trust than a tippee who is ignorant of the breach. *See* Rapp & Loeb, *Tippee Liability And Rule 10b-5*, 1971 U. ILL. L.F. 55, 69 [hereinafter cited as Rapp & Loeb].

110. *See* Rapp & Loeb, *supra* note 109 at 86. The second prong of the access test of *Cady, Roberts* only considers it to be unfair when a party takes advantage of corporate information who knows it is unavailable to those with whom he deals. 40 S.E.C. at 912.

111. 44 S.E.C. at 648.

112. *See* Comment, *Investors Management Company And Rule 10b-5—The Tippee At Bay*, 72 COLUM. L. REV. 545, 552 (1972), in which it is noted that a tippee who publicly discloses corporate information may still encounter the risk of a 10b-5 violation.

113. Of course, a tippee who receives information from a person not privy to corporate affairs may be liable. A tippee may acquire inside information from another tippee. This is what happened in *Investors Management*.

114. 5 A. JACOBS, THE IMPACT OF RULE 10b-5, 3-277 (rev. ed. 1978)[hereinafter cited as JACOBS].

knowledge of inside information before he can tip it. Moreover, the constructive knowledge standard is contrary to the admonition in *Cady, Roberts* that liability be based on actual knowledge by the receipient of the inside character of the information.[115] Of equal force, is the holding in *Ernst & Ernst v. Hochfelder.*[116] Because *Hochfelder* requires some element of scienter—intent to deceive, manipulate or defraud[117]—a plaintiff should be required to prove that a tippee had actual knowledge of the corporate source of his information.[118] Under *Investors Management*, a tippee could negligently trade on nonpublic information with constructive knowledge that it was acquired from a confidential source and nevertheless be found to have violated 10b-5.[119] This result is seemingly in conflict with the holding in *Hochfelder.* The incongruity created is that a person can be a tippee because he should know a fact, but according to *Hochfelder* he cannot be held liable unless he acted with scienter.[120]

Whatever the basis for tippee liability, trading on confidential information by a tippee could be as equally reprehensible as trading on that information by an insider.[121] To prevent the use of nonpublic information by a tippee, the tipper is discouraged from making the initial disclosure which is the first link in the chain of dissemination.[122] A measure designed to deter the tipper from tipping is the imposition of a duty to disclose.[123] The tipper is less likely to risk liability by tipping, which provides no direct pecuniary gain, than the tippee is in trading.[124] Liability is founded on the premise that the tipper's act has

115. *Cf.* 40 S.E.C. at 911 *with* note 100 and accompanying text *supra*. How can a tippee who does not have knowledge of the nonpublic nature of the information disclose it to the public? Such a tippee, if he had reason to know of the corporate source of the information, could be found liable under 10b-5. *But cf.* BROMBERG, *supra* note 12, § 7.5(6)(c), at 190.16.

116. 425 U.S. 185 (1976).

117. *Id.* at 201. *Hochfelder* did not decide whether reckless conduct is sufficient to establish scienter.

118. *Id.* at 193, n.12. Some courts have held that a showing of negligence is sufficient to constitute scienter under 10b-5. *See, e.g.*, White v. Abrams, 495 F.2d 724, 730 (9th Cir. 1974); Myzel v. Fields, 386 F.2d 718, 735 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

119. *Accord* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith Inc., 495 F.2d 228 (2d Cir. 1974).

120. JACOBS, *supra* note 114, at 3-282.

121. 401 F.2d at 852-53.

122. Kuehnert v. Texstar Corp., 412 F.2d 700, 706 (5th Cir. 1969) (J. Godbold, dissenting opinion), *aff'g* 286 F. Supp. 340 (S.D. Tex. 1968).

123. A tipper does not breach 10b-5 if his tippee neither tips nor trades, though there is no judicial authority on the issue. *See* BROMBERG *supra* note 12, at § 7.5(4), 190.1.

124. Comment, *Deterrence of Tippee Trading Under Rule 10b-5*, 38 U. CHI. L. REV. 372, 379 (1971).

indirectly damaged the investor to as great a degree as if the tippee had traded on the information.[125] From an equity standpoint, a tipper should have a duty to disclose because he enables another to profit by the use of information he is barred from exploiting.[126] Imposition of a duty to disclose also assures the investor of the right to a civil action against the tipper.[127] Since a tippee who does not know or have reason to know that the information was of a corporate origin will not be held liable, the availability of a legal action against the tipper may be the investor's only remedy.[128]

3. Special Relationship

Although 10b-5 liability has largely attached to insiders and tippees, the finding of a special relationship remains useful in establishing a duty to disclose under two instances. Traditional fiduciary concepts have usually been utilized to create a special relationship between a broker[129] and his customers. A duty arises, not because the broker possesses nonpublic inside information, but because the broker occupies a position of trust and confidence in relation to his customers. A broker usually possesses information which relates solely to the market. For the most part, this market information[130] is public and, at least theoretically, obtainable by the broker's customers. Nevertheless, a broker has a duty to "disclose to his customer, toward whom he acts

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125. Rapp & Loeb, *supra* note 109, at 80. Unlike trading on tipped information, tipping cannot be based on restitution for unjust enrichment since a tipper, in that capacity, may only tip and not reap any profit for his own account. *Id.*

126. 82 HARV. L. REV. 938, 942 (1969).

127. A tipper is liable to persons trading with his direct and indirect tippees. *See generally* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974) (liability extended to non-trading tippers); Elkind v. Liffett & Meyers, Inc., 66 F.R.D. 36, 41-44 (E.D.N.Y. 1975). In *Kuehnert v. Texstar Corp.*, 412 F.2d 700 (5th Cir. 1969), a tippee who sued his tipper because he was given an inferior tip was denied recovery because he was *in pari delicto* with the tipper.

128. The Second Circuit in *Texas Gulf* gave its reasons for extending liability to tippers:

> [W]ithout such a remedy, insiders could easily evade their duty to refrain from trading on the basis of inside information. Either the transactions so traded could be concluded by a relative or an acquaintance of the insider, or implied understandings could arise under which reciprocal tips between insiders in different corporations could be given.

S.E.C. v. Texas Gulf Sulphur Co., 446 F.2d 130 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971). If the tippee is outside the court's jurisdiction the tipper may be the only party against whom the injured party could assert his remedy. *See* Rapp & Loeb, *supra* note 109, at 80.

129. A broker is "any person engaged in the business of effecting transactions in securities for the account of others. . . ." Securities Exchange Act of 1934, 15 U.S.C. § 78(c)(a)(4) (1976).

130. A definition of market information is provided at note 13 *supra*.

in the position of a fiduciary, *all facts* . . . pertaining to the customer's purchases,"[131] including those which are public. In contrast to an insider or tippee, whose duty is founded on superior access and possession of inside information, the liability of a broker is actuated by his superior access to market information and his fiduciary relationship.

The other instance in which 10b-5 liability may attach, because of a special relationship, involves the issuer itself. No apparent reason exists for differentiating between trading by the issuer and trading by an insider or tippee.[132] Initially, it might appear that the imposition of a duty upon the issuer will conflict with the fiduciary duty of directors and officers to purchase the corporation's securities at the lowest price. The ready answer to this quandry is that any obligation which management may have under local law to reacquire a corporation's securities at bargain prices is subservient to the issuer's duty to disclose pursuant to 10b-5.[133] The issuer, then, may be liable for nondisclosure to the same extent as an insider or tippee.

4. Duty to Disclose Market Information?

Examination of recent decisions indicate a predilection to erode the relationship requirement of *Cady, Roberts*. In *S.E.C. v. Great American Industries Inc.*,[134] the United States Court of Appeals for the Second Circuit expressed a willingness to extend the duty of disclosure beyond that resulting from application of insider analysis. In *Great American*, the SEC sought to enjoin violations of 10b-5 by persons who sold mining properties to Great American in exchange for its stock. The seller failed to notify Great American that a substantial part of the selling price included finder's fees. The majority of the court, sitting *en banc*, did not decide whether the seller had a duty of disclosure, because the facts presented involved more than were nondisclosure.[135] In a concurring opinion, however, Judge Kaufman forcefully emphasized that, at least in injunctive actions, 10b-5 should not be circumscribed by traditional notions of fiduciary responsibility.[136]

131. Wohl v. Blair & Co., 50 F.R.D. 89, 91 (S.D.N.Y. 1970) (emphasis added). "The broker has a high standard of fair dealing and full disclosure imposed upon him flowing from the reliance customers place in his advice and expertise." R. FROME & V. ROSENZWEIG, SALES OF SECURITIES BY CORPORATE INSIDERS 176 (1975).

132. Disclosure is not required when securities, which are not convertible, are callable at the issuer's option. 6 *Loss*, *supra* note 10, at 1453.

133. *Id*. at 1453-54.

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

135. 407 F.2d at 460-61.

136. The majority of the court concluded that "[to read] 10b-5 as placing an affirmative duty of disclosure on persons who . . . did not occupy a special relationship to a

Great American demonstrates the judiciary's proclivity to further expand established fiduciary concepts. A judicial inclination to distend 10b-5 was finally transformed into judicial edict in *United States v. Chiarella.*[137] The defendant in *Chiarella* was employed as a "markup man"[138] in the composing room of Pandick Press, a firm specializing in the printing of various financial papers required for the invitation of tender offers. To avoid an anticipatory rise in the market price of a target company's stock, confidentiality was preserved by having the type set with vital information absent or in code. Undaunted, Chiarella was able to decipher the code and determine the names of the target companies.[139] He then purchased shares of the target's stock and immediately sold out after public announcement of the tender offers.[140] Shortly thereafter, the SEC investigated Chiarella's activities. The investigation resulted in Chiarella's agreement to execute a consent decree and disgorge his profits to the sellers from whom he has purchased the stock. He was subsequently indicted and convicted of willful violations of section 10(b) and rule 10b-5.[141]

On appeal to the United States Court of Appeals for the Second Circuit Chiarella argued that he was not an insider of the target companies and, therefore, had no duty to the selling shareholders.[142] The court refused to accept this argument on the grounds that insider status was simply irrelevant.[143] In so doing, the court announced an

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seller or buyer of securities, would be occupying new ground and would require most careful consideration." *Id.* at 460. Judge Kaufman seemed prepared 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 . . . [T]he rule's proscription is considered to be 'closer to unfairness than fraud'. . . .
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> . . .
>
> [A]ny claim that material facts were withheld . . . must be scrutinized with care, whether or not there would have been liability at common law for such a deed.

Id. at 462-63 (Kaufam, J., concurring).

137. 588 F.2d 1358 (2d Cir. 1978), *rev'd,* 100 S. Ct. 1108 (1980).

138. Chiarella was the first person to receive copies from the customer. After he selected the type front and page layout the manuscript was sent out to be typeset. 588 F.2d at 1363.

139. The target's name was deduced by use of other information in the documents such as price histories, par values, and the number of letters in the fictitious corporate name. *Id.* at 1363.

140. Between September 1975 and November 1976 Chiarella's trading netted him a profit of more than $30,000. *Id.*

141. The indictment was brought under § 32(a), the penalty provision of the 1934 Act, 15 U.S.C. § 78ff(a). This section provides criminal penalties for wilful violations of the securities laws.

142. 588 F.2d at 1364.

143. *Id.*

unprecedented rule for nondisclosure liability under rule 10b-5. The Second Circuit said 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."[144] Support for this novel test was drawn from the broad remedial purpose of the antifraud provisions. To ensure that all investors have relatively equal access to material nonpublic information the court declared that 10b-5 should be equally applicable to the market insider as it is to the corporate insider.[145]

Of particular importance was the court's attempt to distinguish Chiarella's conduct from that of the tender offeror's, by reasoning that an offeror is not a market insider.[146] The foundation for the distinction is that an offeror does not receive nonpublic information, as Chiarella did, but creates it. Furthermore, an offeror undertakes an economic risk by making a tender offer at a premium above the pre-offer price, based on its evaluation of market information. In assuming a risk an offeror serves a useful function within the market, by forcing the market to reflect a fair price.[147] Conversely, Chiarella's market activity, for which he assumed virtually no economic risk, had an adverse effect on the market by creating an artificial demand for the stock of the target companies.[148]

In reversing the Second Circuit's decision, the United State Supreme Court rebuked the Second Circuit's failure to identify a relationship between Chiarella and the target companies or the sellers.[149] The Supreme Court held that a rule which makes trading on market information fraudulent, because it is unfair, suffers from two defects. First, financial unfairness does not, in every instance, constitute fraudulent activity under 10b-5.[150] Second, and more fundamentally, there must be a duty to disclose to make silence fraudulent.

Chiarella's activities, even though egregious, were insufficient to trigger a duty under established doctrine. There was no fiduciary relationship to the selling stockholders or to the target companies.[151] It

144. *Id.* at 1365. If one cannot disclose then one must abstain from buying or selling. *Id.*

145. *Id.*

146. *Id.* at 1366.

147. *Id.* at 1367 (citing H.R. REP. NO. 1383, 73d *Cong.*, 2d *Sess.* 11 (1934)).

148. 588 F.2d at 1367.

149. 100 S. Ct. 1108, 1116 (1980).

150. *Id.* (citing Santa Fe Indus. Inc. v. Green, 430 U.S. 462, 474-77 (1977)).

151. 100 S. Ct. at 1117. Early in the majority opinion the Supreme Court seemed to imply that a complete stranger who deals with sellers over an impersonal market exchange has no duty to disclose. As will be demonstrated, later portions of the opinion are indicative of a contrary implication.

would indeed be a strained distinction to discern any difference between Chiarella's purchases and the open market purchases made by the offerors, who possessed the same information.[152] Under *General Time* the purchase of stock by the offerors would not have been a rule 10b-5 violation because the information was not acquired from the target companies.[153] Analytically, it should be of no consequence that the information was created by the offeror companies rather than generated through Chiarella's efforts. In either event, the information did not derive from the issuer corporation.

In stark contrast to the broker in *Cady, Roberts* and the employees in *Texas Gulf*, Chiarella was not an insider. At no time did he have access to or possession of inside information.[154] Nor was inside information given to him by a tipper. The information was obtained indirectly from the offerors who were free to trade on the information without contemplation of a 10b-5 violation. To be subject to the "disclose or abstain" rule of *Texas Gulf* an investor must be in possession of "material *inside* information."[155] The information must originate from the issuer company. Similarly, *Cady, Roberts* requires that the information derive from a source within the company whose shares are traded.

Chiarella seems unwilling to extend the scope of nondisclosure liability beyond that established in *Cady, Roberts*. A reason for not expanding the duty is that it is an act that should not be within the province of judicial decisionmaking. The Supreme Court observed that Congress has provided detailed and specific regulation when the need for expansion has been required.[156] Through the William's Act, for example, Congress has, in effect, created a duty of disclosure when a tender offeror purchases more than five percent of a target company's stock.[157] The information which the offeror possesses is market information, but the legislature has opined that it be regulated.

It is clear that the Supreme Court is not expanding the duty beyond that established in *Cady, Roberts*. *Chiarella*, however, could reasonably be interpreted as restricting the duty to disclose. The Court's repeated references to "fiduciary duty"[158] infers that the duty

152. *See* notes 93-95 *supra*.

153. It is assumed that the prospective tender offeror purchases less than five percent of the target stock. *See* notes 92 and 93 *supra*.

154. Chiarella did have inside information of the tender offeror companies. He abstained from trading in the stock of the offeror companies and was not held liable on this basis.

155. 401 F.2d at 848 (emphasis added).

156. 100 S. Ct. at 1117.

157. *See* note 93 *supra*.

158. 100 S. Ct. at 1114, 1115, 1117.

under 10b-5 should go no further than that required under state law. The better reasoned interpretation indicates that the Court is merely circumscribing the decision in *Cady, Roberts*. Careful inspection of the Court's language compels this conclusion.

An insider does not stand in a fiduciary relation to a purchaser of stock (i.e. a non-stockholder). But *Chiarelli* recognized a duty to disclose owed to a purchaser of stock.[159] *A fortiori, Chiarella* did not restrict the duty established in *Cady, Roberts,* which requires disclosure to the purchaser of stock. Perhaps it is the Court's analysis which adumbrates the effect its decision has on *Cady, Roberts. Chiarella* may be interpreted as requiring proof of a fiduciary relationship, but not necessarily one between the alleged violator and the investor. The fiduciary obligations owed to the corporation by virtue of the insider's corporate position may be the factor which gives rise to the duty an insider owes to the prospective purchaser of stock.[160]

Although market information may provide a trading advantage, *Chiarella* refused to extend a duty of disclosure to include the group of market participants to whom market information is available. Nevertheless, application of the market insider approach goes a long way in bridging the gap in structural disparities in access to material information.[161] Since the securities laws seek to foster public investment by instilling confidence in the market, a rule which prevents exploitation of structural informational advantages would help to achieve this goal.[162] On the other hand, a rule which requires disclosure of all nonpublic information closely resembles adoption of a parity of information requirement, which is a vague guideline with which to license appropriate conduct applicable to all market participants. In terms of legal theory, such an approach represents a radical departure from current case law, because no relationship between the trading parties or with the affected corporation is required.[163]

As a practical matter, imposition of a duty may become difficult in

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159. *Id.* at 1114. Because the Court treats insiders separately from fiduciaries it is fair to conclude that an insider need not have a relationship of trust and confidence to the person with whom he trades. *Id.* at 1115.

160. *Chiarella* accepted the reasoning of Judge Learned Hand that,

> the director or officer [i.e. insiders] assumed a fiduciary relation to the buyer by the very sale; for it would be a sorry distinction to allow him to use the advantage of his position to induce the buyer into a position of a beneficiary although he was forbidden to do so once the buyer had become one.

Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951). *See* 100 S. Ct. at 1114, n.8.

161. Fleischer, *supra* note 12, at 808.

162. *Id.* at 816.

163. *Id.*

attempting to trace information to determine if it was derived from a nonpublic source. Considerable difficulties also arise in defining an informational advantage. The sophisticated financial analyst who brings to bear his superior ability to exhume additional facts from nonpublic information, under the market insider theory, would seemingly be required to disclose the bare nonpublic information, if not also the results of his financial analysis.[164] Were the analyst only required to disclose the bare nonpublic facts administrative havoc would prevail, because the analyst would have to sift through a morass of information to separate the bare facts from the fruits of his financial savvy. This same problem would result if possession of the nonpublic information were relayed to a tippee. Consistency suggests that the tippee be required to disclose not only the nonpublic information, but also any informational advantage gained through his, and/or the tipper's economic acumen.

The unlimited number of ways in which nonpublic information may be acquired makes it difficult for the investor to know what to disclose. Uncertainty, therefore, will probably cause market participants not to trade and "place undesirable inhibitions on investor trading."[165]

The parity of information approach does not require a showing of fraud. In *Santa Fe Industries Inc. v. Green*,[166] however, the United State Supreme Court held that not every instance of financial unfairness will constitute fraudulent activity under 10b-5.[167] The applicability of Section 10(b) and rule 10b-5 depends upon the establishment of fraud. Section 10(b) may be a catch-all provision, "but what it catches must be fraud."[168]

In *Chiarella*, the Supreme Court was afforded the opportunity to decide just how far 10b-5 went in catching fraud, but did not resolve the issue. The majority of the Court specifically declined to decide whether the breach of the fiduciary duty Chiarella owed to the offeror companies[169] was sufficient to support a 10b-5 action brought by the

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164. Under a party of information approach the astute financial analylist could be required to disclose the results of his economic analysis to the poor widow in Maine who acts without the aid of similar financial skills.

165. *Id.* at 817.

166. 430 U.S. 462 (1977).

167. *Id.* at 474-77.

168. 100 S. Ct. at 1118.

169. Chiarella did not dispute the proposition that he had "violated his duty as an agent of the offeror corporations not to use their confidential information for personal profit." *Id.* at 1123 (Burger, C.J., dissenting).

selling shareholders.[170] Not exercising similar deference, Chief Justice Burger proposed that 10b-5 activated when an informational advantage is obtained by unlawful means, such as by the breach of a fiduciary relationship.[171] According to Chief Justice Burger one must examine the *manner* in which the trading party has obtained his trading advantage to determine if 10b-5 has been contravened.[172] Thus, the commission of fraud, irrespective upon whom it is committed, would require disclosure of the ill-gotten information or refrainment from trading. Chief Justice Burger relied on Chiarella's obligation not to defraud the offeror corporations in creating a duty to the disgruntled investors. The theory for the creation of the duty is built on the unlawfulness of purloining nonpublic information.

Supportive of Chief Justice Burger's theory is the literal language of section 10(b) and rule 10b-5. These anti-fraud provisions extend to "any" fraudulent device or contrivance in connection with the purchase or sale of securities.[173] Rule 10b-5 does not categorize the "persons" against whom fraud must be committed for it to apply. In short, a literal reading of 10b-5 would find Chiarella's misappropriation of confidential information, in breach of his fiduciary obligation to the offeror companies, sufficient to constitute fraud against the investors with whom he traded.

"But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary?"[174] Chiarella was a fiduciary of the offeror corporations, not a fiduciary of the investors with whom he traded. He did not have a duty to take a position non-adverse to the selling shareholders.

Chief Justice Burger's dissent is difficult to justify with the holding in *Green*. *Green* held that not all breaches of fiduciary duty are adequate to establish a violation of 10b-5.[175] *Green* rejected mere reliance on the term "fraud" to bring within the scope of 10b-5 all breaches of fiduciary duty in connection with a securities transaction.[176] Moreover,

170. In opposing certiorari, the United States argued that the defendant's breach of duty to the offerors was adequate to support a conviction for violation of 10b-5. *See Brief for the United States in opposition to petition for a writ of certiorari in U.S. v. Chiarella*. The majority in *Chiarella* did not decide the merit of this theory because it was not submitted to the jury in the district court. 100 S. Ct. at 1118.

171. *Id.* at 1120 (Burger, C.J., dissenting).

172. *Id.* at 1120-21 (citing Keeton, *Fraud-Concealment and Non-Disclosure*, 15 TEX. L. REV. 1, 25-26 (1936) (emphasis added)).

173. *See* notes 1 and 2 *supra*.

174. S.E.C. v. Chenery Corp., 318 U.S. 80, 85-86 (1943).

175. 430 U.S. at 476.

176. *Id.* at 472.

unlike the minority shareholders in *Green* whose claim of fraud was "in connection with the sale" of stock[177] the offeror companies in *Chiarella* were not sellers of the target company's stock. Under the *Birnbaum* doctrine,[178] no actionable violation of 10b-5 could have been successfully asserted by the offeror companies because they did not trade with Chiarella. In effect, Chief Justice Burger has resurrected a cause of action for the benefit of the aggrieved investors, based on a fraud committed against parties who themselves had no standing to sue under 10b-5.

Stare decisis dictated that there was no duty to disclose in *Chiarella*. The aberrational factual setting in which *Chiarella* arose is simply not an appropriate case for the adoption of a new and expansive basis for 10b-5 liability.

III. CONCLUSION

The broad language of 10b-5 has been used as a mechanism to effectuate the prophylactic features of the Securities Exchange Act of 1934. Consistent with the underlying tenets of a competitive economy the Act was designed to foster public confidence in the securities market. In pursuit of this end, the judiciary has gradually expanded the duty of disclosure under the Act's anti-fraud provisions. But the imposition of a duty has been subject to one unyielding common denominator throughout the period of its expansion. The *sine qua non* of a 10b-5 duty of disclosure is the finding of a fiduciary relationship between the trading parties, or a nexus between the alleged violator and the affected corporation.

Salutory as the anti-fraud provisions may be, the United States Supreme Court has acknowledged that limitations should be placed on the scope of 10b-5. General references to the remedial purpose of the Securities Exchange Act will no longer support a broad interpretation of 10b-5.[179] An overly expansive approach would render the other ex-

177. In *Green*, the defendant, Santa Fe Industries, attempted a statutory merger with Kirby Lumber Company, of whose stock it owned 15 percent. Pursuant to Delaware's "short form merger statute" the defendant offered to make payment for the share of Kirby's minority shareholders, whose consent of the merger was not required. The minority shareholders objected to the merger and, instead of petitioning for the payment of the fair market value of their shares as determined by a court-appointed appraiser, brought an action under 10b-5 to set aside the merger as fraudulent. *Id.* at 465-68.

178. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir. 1952), which met with the approbation of *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), limited private relief for violation of 10b-5 to persons who are either purchasers or sellers of a security.

179. *See* Touche Ross & Co. v. Redington, 442 U.S. 560 (1979).

press civil liability sections of the securities Act superflous, and would be inconsistent with the limitations Congress built into those sections.[180] If the duty to disclose needs to be expanded, congressional action or SEC rulemaking will be a more appropriate response than stretching the existing law to cover perceived gaps in rule 10b-5.[181]

Thomas J. Troetti

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180. 401 F.2d at 867-68.
181. 588 F.2d at 1376 (Meskill, J., dissenting).