Rule 10b-5 and the Duty to Disclose Market Information: It Takes a Thief

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NOTES

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INTRODUCTION

Rule 10b-5,¹ adopted by the Securities and Exchange Commission (SEC) in 1942 pursuant to its rule-making power under section 10(b) of the Securities Exchange Act of 1934,² prohibits "any person" from making materially inaccurate or incomplete statements or employing any other fraudulent scheme or practice in connection with the purchase or sale of securities.³ Neither the

1 17 C.F.R. § 240.10b-5 (1980).
2 15 U.S.C. § 78j(b) (1976). Section 10(b) reads in pertinent part:
   It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange
   
   (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
3 Rule 10b-5 provides:
   It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
   (1) to employ any device, scheme, or artifice to defraud,
   (2) 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
   (3) 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.

Several remedies have been created for violations of the statute and the rule. A violation of section 10(b) or rule 10b-5 is criminally punishable by a fine of up to $10,000, imprisonment for up to 5 years, or both. 15 U.S.C. § 78ff (1976). In addition, the SEC is authorized to seek injunctive relief against "any person [who] is engaged or is about to engage

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statute nor the rule, however, expressly creates liability for mere nondisclosure of material nonpublic information.\(^4\) Reflecting common-law notions of fiduciary responsibility,\(^5\) courts traditionally imposed an affirmative disclosure obligation under rule 10b-5 only on "insiders,"\(^6\) persons standing in a relation of trust and confidence to the issuer of the securities.\(^7\) More recently, the courts\(^8\) and the SEC\(^9\) have demonstrated an inclination to extend the an-

\(\text{in acts or practices constituting a violation}^{10}\) of section 10(b) or rule 10b-5. 15 U.S.C. § 78u(d) (1976). The courts have also granted ancillary or equitable remedies, including, \textit{inter alia}, disgorgement of profits and rescission. \textit{E.g.,} Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), \textit{cert. denied}, 414 U.S. 910 (1973); SEC v. Manor Nursing Center, Inc., 458 F.2d 1082 (2d Cir. 1972); SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301 (2d Cir.), \textit{cert. denied}, 404 U.S. 1005 (1971). Finally, under various provisions of the Securities Act of 1934, several administrative remedies may be pursued by the SEC for violations of rule 10b-5 by brokers, dealers, members of a national securities exchange, or a member of the National Association of Securities Dealers. \textit{See generally} Jacobs, \textit{Judicial and Administrative Remedies Available to the SEC for Breaches of Rule 10b-5}, 53 ST. JOHN'S L. REV. 397, 422-34 (1979). The remedies available to the SEC for violation of section 10(b) or rule 10b-5 do not exhaust the extent of the wrongdoer's possible liability. Although there is no express provision within the Securities Exchange Act of 1934 which provides for civil liability for breach of the rule, an implied private right of action has nonetheless been recognized for over 30 years. \textit{See Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).}

\(\)\(^*\) \textit{See notes} 49-50 and accompanying text \textit{infra.}

\(\)\(^*\) \textit{See notes} 39-40 and accompanying text \textit{infra.}


\(\)\(^*\) The term "insider" traditionally has been held to encompass only those persons subject to the proscriptions against "short swing" trading under section 16 of the Securities Exchange Act of 1934, 15 U.S.C. § 78p (1976), which applies to officers, directors, and to ten percent shareholders of the corporation issuing the security involved. \textit{See supra note} 3, \textit{at} § 66.02[a]. For the last decade, however, "tippees" of the foregoing classes of persons also have been held to be "insiders" within the ambit of rule 10b-5's affirmative duty of disclosure. \textit{See note} 100 and accompanying text \textit{infra.}


\(\)\(^*\) \textit{See Marcus, Lawyer Charged With Insider Trading, Nat'l L.J., Mar. 10, 1980, at 6, col. 2; Miller, S.E.C. Cracking Down on Trading By Insiders, N.Y. Times, Mar. 7, 1980, at D6, col. 1. According to Theodore A. Levine, associate director of the SEC's enforcement division, there has been an increase in insider trading in recent years primarily because of the quick profits that can be made by trading on advance knowledge of an impending tender offer. Miller, \textit{supra}, N.Y. Times, Mar. 7, 1980, at D6, col. 5. Indeed, SEC officials are reported to have said that "few insider transactions are actually spotted and that such trading is rampant." \textit{Id.}}\]

In an effort to hasten the trend expanding the 10b-5 duty of disclosure, the SEC accelerated its enforcement activity in the area of insider trading. This "commission crackdown" has been aimed in part at persons other than the traditional "insider." Commenting on the first case in which the SEC successfully sought injunctive relief under rule 10b-5 against the
tification protections of the rule beyond these common-law parameters, indicating that an affirmative disclosure obligation might apply to any person in possession of material nonpublic information with knowledge that it is not available to the public generally.\textsuperscript{10} This trend was checked, however, by the Supreme Court's recent decision in \textit{Chiarella v. United States},\textsuperscript{11} which held that in the absence of a relation of trust and confidence between the parties,\textsuperscript{12} mere possession of material nonpublic information generated by sources outside the issuer does not give rise to a disclosure obligation under rule 10b-5.\textsuperscript{13}

The rule 10b-5 duty to disclose is an element to be proved in private actions and SEC enforcement proceedings based on fraudulent nondisclosure, as well as in criminal prosecutions by the Justice Department.\textsuperscript{14} Therefore, although \textit{Chiarella} arose in a criminal context, it is likely to have ramifications on all aspects of 10b-5 enforcement. This Note will conclude that the Supreme Court's special relationship standard is a departure from well-reasoned lower court and SEC decisions and will constitute an impediment to the effective enforcement of rule 10b-5 by all potential complainants. Initially, the Note will trace the development of the 10b-5 disclosure obligation from its common-law origins through the significant nondisclosure precedent under the statute and the rule. Emphasis will be placed on those classes of persons subject to a duty to disclose. After an examination of \textit{Chiarella} itself, the implications of the decision for the potential liability of tippees and outsiders will be discussed. Finally, the effect of \textit{Chiarella} on the private right of action under rule 10b-5 and on the injunctive powers of the SEC will be analyzed.

\footnotesize{\textit{issuer's counsel, see SEC v. Hall, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. }\textsuperscript{2}97,292 (D.D.C. 1980), Mr. Levine stated that the \textit{Hall} case "shouldn't be viewed as anything more than the Commission saying that nobody's immune from insider trading restrictions." Marcus, supra, at 6, col. 2 (emphasis added).


\textsuperscript{11} 445 U.S. 222 (1980).

\textsuperscript{12} Id. at 227.

\textsuperscript{13} Id.

\textsuperscript{14} See 5B A. Jacobs, supra note 3, § 263, at 11-289.}
Nondisclosure at Common Law

The common law generally recognized a cause of action for deceit based on half-truths or misrepresentations; no such action lay, however, for mere nondisclosure of material facts within the knowledge of one party to a transaction. Based on a competitive business ethic, this rule rewarded a party's diligence and business acumen by permitting him to exploit another's ignorance, provided he did not actively mislead the other. Although such conduct could be viewed as morally contemptible, the preservation of morality was not considered the function of the courts. "Simple reticence," said Lord Campbell over a century ago, "does not amount to legal fraud, however it may be viewed by moralists."

An exception to this general rule arose when the party in possession of undisclosed material information was under a duty to disclose it. Ordinarily, an obligation to speak was not found absent a fiduciary relationship between the parties. Thus, for example, a duty to disclose was imposed where the relationship between the parties was that of principal-agent, executor-beneficiary, or

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16 W. PROSSER, HANDBOOK ON THE LAW OF TORTS § 106, at 695-96 (4th ed. 1971). Ordinarily in any transaction between two or more parties, there will be one party who, because of his diligence and shrewdness, will possess superior knowledge. Despite this fact, he normally is under no obligation to offer it to the less informed since an individual is entitled to benefit from his superior insight. See Conant, Duties of Disclosure of Corporate Insiders Who Purchase Shares, 46 CORNELL L.Q. 53, 55-57 (1960); Goldfarb, Fraud and Nondisclosure in the Vendor-Purchaser Relation, 8 W. RES. L. REV. 5, 9 (1956).


20 Goldfarb, supra note 16, at 32; Keeton, Fraud—Concealment and Non-Disclosure, 15 TEX. L. REV. 1, 11 (1936); see Restatement (Second) of Torts § 551 (1977). An affirmative disclosure obligation also has been imposed on a party when he knows that the other party with whom he is contracting is relying on his silence and is mistaken as to a material fact. See Bank v. Board of Educ., 305 N.Y. 119, 111 N.E.2d 238 (1953).
trustee—cestui que trust.\textsuperscript{21} No such duty existed, however, where the relation of the parties was merely that of vendor and purchaser.\textsuperscript{22} As one commentator has noted, a vendor at common law was “hardly ever” under an obligation to disclose, and a purchaser was “almost never” under such an obligation.\textsuperscript{23}

Prior to the enactment of the federal securities laws, these principles were equally applicable in securities transactions: the duty of disclosure was triggered only if a relationship of trust and confidence could be established between purchaser and seller.\textsuperscript{24} Consequently, the issue of liability for nondisclosure frequently arose in a corporate fiduciary context. In these early cases, the courts were presented with the question whether a fiduciary obligation was owed by corporate officers or directors to the corporation’s stockholders individually.\textsuperscript{25} Under traditional fiduciary concepts, if corporate management were deemed to serve in a fiduciary capacity vis-a-vis the individual stockholders, an officer or director would be required to divulge any material information which he had obtained by virtue of his position before effecting a purchase of the corporation’s securities.\textsuperscript{26} The courts, however, were split on this issue.\textsuperscript{27} An early majority view held that while an officer or director owed fiduciary duties to the corporation which he served and to its stockholders collectively, he did not have fiduciary responsibilities to individual stockholders merely because of his position.\textsuperscript{28} It was reasoned that the affairs of the company were constructively known to the shareholders since the books of the


\textsuperscript{26} See notes 19-23 and accompanying text \textit{supra}.


corporation were open to examination. Moreover, in dealing with an officer or director, a stockholder could elicit any undisclosed information by inquiring as to whether the officer or director possessed any secret knowledge. Thus, it was concluded that officers and directors could trade as "outsiders" without disclosing non-public information in their possession as long as they did not affirmatively act or speak wrongfully.

A minority of courts rejected the "constructive knowledge" theory as inconsistent with economic reality. According to this view, it would be virtually impossible for an ordinary shareholder in a large publicly held corporation to be privy to the same information to which an officer or director had access. The minority courts concluded that although officers and directors were not strictly trustees for shareholders, they were nonetheless "quasi-trustees" with respect to the individual stockholder's shares. When trading in securities of their own corporation, therefore, officers and directors acted "in a relation of scrupulous trust and confidence." The minority also noted that the paramount duty of a corporate agent to maintain the secrecy of confidential corporate information was not a license to use that secret information to the disadvantage of shareholders to whom he was also responsible.

30 If a stockholder made an affirmative inquiry about the condition of the company, the officer or director had to respond truthfully. Otherwise, he was answerable in damages to the stockholder. Geller v. Transamerica Corp., 53 F. Supp. 625, 630 (D. Del. 1943); Waller v. Hodge, 214 Ky. 705, 283 S.W. 1047 (1926).
32 The majority view also has been criticized by most text writers and commentators as "a rule of unconscionable laxity." H. Ballantine, Corporations § 80, at 212-13 (rev. ed. 1946).
33 Dunnett v. Am., 71 F.2d 912, 918 (10th Cir. 1934); see Oliver v. Oliver, 118 Ga. 362, 368, 45 S.E. 232, 234-35 (1903).
34 Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903); Hotchkiss v. Fischer, 136 Kan. 530, 16 P.2d 531 (1932); Markey v. Hibernia Homestead Ass'n, 186 So. 757 (La. Ct. App. 1939); Staker v. Reese, 82 W. Va. 764, 97 S.E. 641 (1919). As Judge Lamar, later Associate Justice of the United States Supreme Court, stated in Oliver:

No 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, ... but a quasi trustee as to the stockholder's interest in the shares.

118 Ga. at 367, 45 S.E. at 233-34.
35 See Oliver v. Oliver, 118 Ga. 362, 368, 45 S.E. 232, 234 (1903).
36 Id.
"The very fact that [an officer or director] cannot disclose prevents him from dealing with one who does not know, and to whom material information cannot be made known."  

Subsequently, an intermediate position arose which in large part adopted the minority "disclose or refrain from trading" rule. Under this view, the officer or director had a fiduciary responsibility to disclose material nonpublic information if there existed certain "special facts" which could significantly affect the value of the stockholder's shares, yet were not ascertainable by examination of the corporation's books. These special circumstances included imminent and extraordinary corporate action, such as an impending merger or other corporate reorganization, or a liquidation. This position eventually was adopted by a majority of jurisdictions.

The common-law duty to disclose nonpublic corporate information, however, continued to have limited application. An officer or director's obligation to disclose, if it existed at all, was premised on either a fiduciary relationship or one of trust and

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37 Id.

38 One commentator has described this intermediate viewpoint as "a compromise between the laissez faire attitude of [the majority] cases and the paternalistic philosophy of the [minority] cases." W. PAINTER, FEDERAL REGULATION OF INSIDER TRADING 17 (1968).

39 See Strong v. Repide, 213 U.S. 419 (1909); Agatucci v. Corradi, 327 Ill. App. 153, 63 N.E.2d 630 (1945); Buckley v. Buckley, 230 Mich. 504, 202 N.W. 955 (1925); Fischer v. Guaranty Trust Co., 259 App. Div. 176, 18 N.Y.S.2d 328 (2d Dep't 1940). See also Chiarella v. United States, 445 U.S. 22, 228 n.10. In Strong, the defendant was a director and owner of three-fourths of the shares in a corporation whose single valuable asset was land. 213 U.S. at 421. After nearing completion of negotiations for the sale of the corporation's land at a sizable sum, the defendant, through his agent, purchased the plaintiff's shares in the corporation without disclosing the negotiations for the sale of the land. Id. Had the plaintiff retained her shares until the completion of the land sale, she would have realized ten times the amount which she received from the defendant for her shares. Id. at 422. Justice Peckham concluded that while the mere status of the defendant may have been insufficient to impose upon him a duty to disclose, id. at 430-31, the "special facts" of the case were more than enough to hold him to a duty to speak prior to purchasing the shares of other stockholders, id. at 431. In reaching his conclusion, Justice Peckham observed that the defendant, in addition to being a director, was also the majority shareholder in the corporation, in charge of its operations, and the chief negotiator for the corporation in the negotiations for the sale of its only valuable asset. Id. at 431.


confidence. Therefore, if a director was selling his shares to a nonshareholder, to whom no fiduciary responsibilities were owing, he had no duty to divulge material facts which he had obtained by virtue of his inside position. Nor was a majority shareholder obliged to disclose corporate information in his possession, even when dealing with other shareholders. Moreover, there is authority that the duty to disclose was nonexistent, even as to officers and directors, if the transaction was effected on a national securities exchange. Consequently, with few circumstances triggering an obligation to speak, caveat emptor was the rule of the day.

Nondisclosure Under Section 10(b) and Rule 10b-5

The Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted to bolster investor confidence in the integrity of organized capital markets by “substitut[ing] a philosophy of full disclosure for the philosophy of caveat emptor.” Section 10(b) and Rule 10b-5 prohibited the use of inside information in connection with the purchase or sale of securities. The SEC interpreted these provisions to require the disclosure of material nonpublic information to shareholders in a timely manner. The SEC’s enforcement actions and court cases reinforced the principle that insiders had an obligation to disclose material information to shareholders.


It had never been expressly decided whether trading on undisclosed information could be the basis of a fraud action when the sale had taken place on a securities exchange. In Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933), however, the Supreme Judicial Court of Massachusetts observed:

Purchases and sales of stock dealt in on the stock exchange are commonly impersonal affairs. An 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 then knew affecting the real or speculative value of such shares. Business of that nature is a matter to be governed by practical rules.

Id. at 363, 186 N.E. at 661.


Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); see SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 189 (1963); W. Leuchtenberg, FDR and the New Deal 90-91 (1963); M. Parrish, Securities Regulation and the New Deal 42-43, 180 (1970); A. Schlesinger, History of the New Deal 423-24, 457, 470 (1980); Gadsby, Historical Development of the S.E.C.—The Government View, 28 Geo. Wash. L. Rev. 6, 9 (1959); Moore & Wiseman, Market Manipulation and the Exchange Act, 2 U. Chi. L. Rev. 46 (1934). In his message to Congress in support of the legislation that was to become the Securities Act of 1933, President Franklin D. Roosevelt wrote: “This proposal adds to the ancient rule of caveat emptor, the further doctrine ‘let the seller also beware,’ . . . . It
10(b) of the 1934 Act, derived from the broad antifraud provisions of section 17(a) of the 1933 Act,\(^5\) prohibits any "manipulative or deceptive device or contrivance" in contravention of any rule promulgated by the SEC as "necessary or appropriate in the public interest or for the protection of investors."\(^6\) Rule 10b-5, adopted

\(^{50}\) 15 U.S.C. § 77q(a) (1976); see 3 L. Loss, supra note 44, at 1423. Section 17(a) outlaws fraud by any person in the sale or offer for sale of securities. 15 U.S.C. § 77q(a) (1976).

\(^{51}\) See note 2 supra. Although the legislative history of section 10(b) is sparse, see Hanna & Turlington, Protection of the Public Under the Securities Exchange Act, 21 VA. L. REV. 251, 275 (1935), it does indicate that the section was intended as a "catchall" provision to "deal with new manipulative or cunning devices." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976); see 1 A. Bromberg, supra note 3, at § 2.2. One of the drafters of the 1934 Act commented before the House Committee on Internal and Foreign Commerce:

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
by the SEC pursuant to this rulemaking power, proscribes the making of materially false or incomplete statements or any other fraudulent scheme or practice in connection with the purchase or sale of any security. While rule 10b-5 expressly forbids affirmative misrepresentations and half-truths, it does not expressly address the legality of nondisclosure.

The earliest decisions interpreting the rule indicated that 10b-5 was merely a federal codification of the common-law action for deceit to be applied in securities fraud cases. Thus, in accordance with the principles of common-law fraud, these courts consistently held that mere silence constituted a fraudulent scheme or practice within the proscription of the rule only in the presence of a relationship of trust and confidence. As a result, while rule 10b-5 litigation has no objection to that kind of clause. The Commission should have authority to deal with new manipulative devices.


See note 3 supra. Rule 10b-5 was promulgated in 1942 to close a “loophole” in the antifraud provisions of the federal securities laws by prohibiting fraud in the purchase as well as the sale of securities. SEC Exch. Act. Rel. No. 3230 (May 21, 1942); 8 SEC Ann. Rep. 10 (1942); see note 50 supra. See generally 1 A. Bromberg, supra note 3, at § 2.2; 5 A. Jacobs, supra note 3, at § 5.


See Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964); Tobacco & Allied Stocks, Inc. v. Transamerica Corp., 143 F. Supp. 323 (D. Del. 1956), aff’d, 244 F.2d 902 (3d Cir. 1957). The early decisions applying rule 10b-5 did little to remove the obscurity surrounding the duty of disclosure. See, e.g., Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951); Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa.), modified, 83 F. Supp. 613 (E.D. Pa. 1947); In re Ward La France Truck Corp., 13 S.E.C. 373 (1943). It should be noted that the initial comments on rule 10b-5 doubted seriously that the rule would ever be applied to a noninsider in a pure nondisclosure case. See Note, Purchaser’s Duty to Disclose Under Securities and Exchange Commission Rule X-10B-5, 40 Minn. L. Rev. 62, 64 (1955); 59 Harv. L. Rev. 769, 774 (1946); 44 Ill. L. Rev. 841, 841-42 (1950); 8 St. Louis U.L.J. 241, 245 (1963). As late as 1968, one eminent commentator in the field of securities regulation was to observe:

A careful reading of the bulk of [the rule 10b-5] cases had led the author to the conclusion that decisions construing Rule 10b-5 are creating no new substantive law of torts. Indeed, the courts seem to be importing into the rule modern
erally applied to "any person," the requirement of a fiduciary relationship limited its application to officers and directors trading on nonpublic inside information. In 1951, however, in Speed v. Transamerica Corp., it was finally established that the duty to disclose was a discrete statutory creation.  

Transamerica Corp. (Transamerica) owned a majority interest in Axton-Fisher Tobacco Co. (Axton) and controlled its board of directors. By virtue of its position, Transamerica learned that the cash value of Axton's tobacco inventory greatly exceeded its book value as reflected in the company's annual financial statement and determined, therefore, to capture this inventory appreciation through merger or dissolution of Axton. As part of this plan, Transamerica offered to purchase outstanding shares of Axton class A stock without disclosing its intentions to the selling minority stockholders and without informing them of the actual value of the inventory. The court held that Transamerica was under a duty, as majority shareholder, to inform the minority stockholders of material nonpublic facts to which it had access solely by virtue of its inside position and that its failure to do so violated rule 10b-5. The Speed court grounded its holding, however, on notions of fairness and parity of information, rather than on traditional corporate fiduciary concepts.

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Theories of common law fraud and deceit . . . .


70 Id. In a two-year period, the value of Axton's tobacco inventory had increased by over $2 million. Id. at 835.

71 Id. at 828. Although this appreciation in value could have been captured through a simple sale, the resulting gain would have been subjected to heavy taxation, id. at 837. If, however, Transamerica were able to acquire more than eighty percent of Axton's stock, it could capture the entire appreciation through a tax-free dissolution. Id. at 838.

72 Id. at 828; see note 61 supra.

73 See 99 F. Supp. at 828-29. Apparently the court felt that the disclosure obligation was founded more on the defendant's relationship to the issuer than on his relationship to those from whom he purchased. The court emphasized twice that the information which the defendant failed to disclose was known to it solely "by virtue of its position" in relation to Axton. Id.

74 Id. at 829.

75 See id. The Speed court stated that its decision was not based on the "narrow and
Speed provided little concrete guidance, however, as to when an affirmative disclosure obligation would arise under rule 10b-5. Consequently, courts for the next decade continued to explain the duty to disclose in terms of a fiduciary obligation while at the same time discounting the notion that liability under the rule was circumscribed by the elements of common-law deceit. Then, in 1961, a more definitive standard for applying the 10b-5 disclosure obligation was enunciated by the SEC in In re Cady, Roberts & Co., which indicated that the duty was not limited to situations where a fiduciary relationship was present.

In Cady, Roberts, the board of directors of the Curtiss-Wright Corporation voted a quarterly dividend at a lower rate than had been declared in previous quarters. During a recess of the board meeting, one of the directors, who was also a registered representative of Cady, Roberts & Co., a broker-dealer, telephoned Gintel, a Cady partner, and left a message that a lower dividend had been declared. After receiving this information, Gintel entered sell orders on the New York Stock Exchange for 7,000 shares of Curtiss-
Wright stock.\textsuperscript{72} The sell orders were executed before the news of the board’s action reached the Exchange.\textsuperscript{73} In the subsequent disciplinary proceeding instituted by the Commission,\textsuperscript{74} the SEC determined that Gintel and Cady had willfully violated rule 10b-5 by failing to disclose the dividend reduction prior to trading.\textsuperscript{75} The Commission established a two-pronged test:

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.\textsuperscript{76}

\textit{Cady, Roberts} involved several questions of “signal importance”\textsuperscript{77} and marked a significant departure from common-law principles of securities fraud.\textsuperscript{78} Under the SEC’s “access test,” any person enjoying any access-yielding relationship with an issuer of securities could be charged with the “correlative responsibilities”

\textsuperscript{72} Id. at 911.
\textsuperscript{73} Id. at 909.
\textsuperscript{74} The respondents were charged with willful violations of rule 10b-5 and section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) (1978). 40 S.E.C. at 908.
\textsuperscript{75} 40 S.E.C. at 911. The Curtiss-Wright director who “tipped” the news of the dividend cut to Gintel died in 1960, and was not, therefore, a party to the proceeding. Id. at 909 n.4.
\textsuperscript{76} The SEC rejected the respondents’ contention that they were under no duty of disclosure because the sales of Curtiss-Wright stock were effected on a national securities exchange. Id. at 914. The Commission concluded that while a lack of privity may preclude recovery in private suits against insiders, see, e.g., Reynolds v. Texas Gulf Sulphur Co., 309 F. Supp. 548 (D. Utah 1970), aff’d in part, rev’d in part, 446 F.2d 90 (10th Cir.), cert. denied, 404 U.S. 1004 (1971); Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S.D.N.Y. 1951), aff’d per curiam, 198 F.2d 883 (2d Cir. 1952), it did not relieve the insider of his obligation to disclose under rule 10b-5. 40 S.E.C. at 914-15. Since securities exchanges were the “primary markets for securities,” the Commission stated, it would be anomalous if exchange transactions were insulated from the antifraud provisions of the securities acts. Id. at 914.

\textsuperscript{77} 40 S.E.C. at 912. See Schoenbaum v. Firstbrook, 268 F. Supp. 385 (S.D.N.Y. 1967), aff’d, 405 F.2d 200 (2d Cir.), aff’d in part, rev’d in part, 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied, 396 U.S. 906 (1969). In Schoenbaum, it was held that both elements of the Cady, Roberts test are necessary before a 10b-5 violation for nondisclosure will arise. The mere buying on inside information, absent inherent unfairness, does not automatically result in a violation of the rule. 268 F. Supp. at 395.
\textsuperscript{78} 40 S.E.C. at 907.
\textsuperscript{79} See id. at 913-14; H. MANNE, INSIDER TRADING AND THE STOCK MARKET 39 (1966). But see 75 HANV. L. REV. 1449, 1450 (1962). Chairman Cary, writing for the Commission, expressly stated that it is inappropriate to confuse the antifraud provisions in the securities acts with the common-law notions of fiduciary relationship. Id.; see note 79 infra.
of an insider, even if that relationship did not fall within traditional "insider" categories. Furthermore, although the district court in Speed had previously alluded to the "unfairness" element in nondisclosure liability, Cady, Roberts was the first decision to recognize expressly that the disclosure obligation created by rule 10b-5 was in part attributable to inherent unfairness. Since the courts preferred to define the limits of 10b-5's duty of disclosure on a case-by-case basis, the Cady, Roberts test won quick judicial approval.

The philosophy of market egalitarianism spawned in Cady, Roberts culminated in 1968 with the landmark decision by the

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79 See 40 S.E.C. at 911. The Commission declared that the affirmative duty to disclose material nonpublic information was not limited to corporate insiders. Id.; see Bromberg, Corporate Information: Texas Gulf Sulphur and Its Implications, 22 Sw. L.J. 731, 740 (1968). Under an access standard, therefore, the Cady, Roberts respondents were subject to a duty of disclosure even though they were not traditional insiders of the corporation from which the nonpublic information was generated. 40 S.E.C. at 912. Cf. James Blackstone Mem. Library Ass'n v. Gulf, Mobile & Ohio R.R., 284 F.2d 445 (7th Cir.), cert. denied, 361 U.S. 815 (1959) (majority shareholder has duty to disclose material information under rule 10b-5); Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa.), modified, 83 F. Supp. 613 (E.D. Pa. 1947) (officer-director has duty of disclosure under rule 10b-5); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951) (controlling shareholder has duty of disclosure under rule 10b-5). The respondents in Cady, Roberts were actually "tippees" of an insider. See 6 L. Loss, supra note 44, at 3561.

80 See note 65 and accompanying text supra.

81 See 40 S.E.C. at 912. The unfairness element stems from the unique informational advantage which an insider possesses when dealing with "outsiders." Brudney, Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws, 93 Harv. L. Rev. 322, 346 (1979); Hetherington, Insider Trading and the Logic of Law, 1967 Wis. L. Rev. 720, 720-21. Brudney describes the unfairness in the insider's informational advantage as a function [not] merely of possessing more information — outsiders may possess more information than other outsiders by reason of their diligence and zeal — but of the fact that it is an advantage which cannot be competed away since it depends upon a lawful privilege to which an outsider cannot acquire access. Brudney, supra at 346. Although the unfairness test had been implicit in the prohibitions against insider trading for some time, see, e.g., Speed v. Transamerica Corp., 99 F. Supp. at 829; In re Ward La France Truck Corp., 13 S.E.C. 373, 380-81 (1943), Cady, Roberts was the first to articulate it. See 40 S.E.C. at 812.

82 Herpich v. Wallace, 430 F.2d 792, 802 (5th Cir. 1970); Kohler v. Kohler Co., 319 F.2d 634, 637-38 (7th Cir. 1963). The SEC has been accused of favoring this ad hoc approach by the judiciary, since the Commission has been considerably influential in the fixing of guidelines to rule 10b-5 by the courts. See H. Manns, supra note 78, at viii.

United States Court of Appeals for the Second Circuit in SEC v. Texas Gulf Sulphur Co. In Texas Gulf Sulphur, the Texas Gulf Sulphur Company (TGS) conducted aerial geophysical explorations, led by a TGS vice president, in eastern Canada in March of 1959. Based on the results of the initial aerial surveys, ground explorations were begun in late October 1963 and, by November 12 of that year, drilling samples had indicated extensive mineralization. When this information was relayed to TGS’s president, he ordered that the results of the drillings be kept secret, even from other TGS employees, officers, and directors. Rumors began to circulate, however, that TGS had discovered a rich mineral deposit, and on April 11, 1964, unauthorized reports of its drilling activities appeared in two American newspapers. Although its explorations indicated that a commercially mineable copper deposit had been found, TGS issued a press release on April 12, stating that the rumors were exaggerated and that the drillings had been inconclusive. Four days later, TGS announced the discovery of at least 25 million tons of copper ore.

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85 401 F.2d at 843. In addition to the TGS vice president, the aerial survey team was comprised of three TGS employees. Id.
86 Id. The aerial surveys indicated unusual variations in the electrical conductivity of the rock beneath the surface, suggesting the presence of commercial sulphide deposits. SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 269 (S.D.N.Y. 1966), rev’d in part, aff’d in part, 401 F.2d 833 (2d Cir. 1968).
87 The commencement of the on-ground explorations was delayed until TGS could acquire rights to the land around the “anomalies” discovered in the aerial survey. 258 F. Supp. at 270.
88 401 F.2d at 843. By visual inspection, a significant concentration of copper and zinc appeared to be present in the sample. Id. These concentrations were verified in a subsequent chemical assay. Id.
89 Id. at 843.
90 Id. at 844.
91 Id. at 862 n.28. Four experts would testify before the district court that they had never heard of a “comparable initial exploratory drill hole in a base metal deposit.” Id.
92 Id. at 845.
93 Id. at 846.
The SEC subsequently brought an action to enjoin TGS and the individual defendants, including two TGS directors and ten other TGS officers and employees, from violating section 10(b) and rule 10b-5.4 Since each of the individual defendants in Texas Gulf Sulphur was an "insider" in the traditional sense,9 liability for nondisclosure could have been established under the Cady, Roberts access test.9 Instead of applying an access standard, however, the Second Circuit found that the defendants had violated rule 10b-5 under a new standard, holding that

anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such information remains undisclosed.97

With the shift in focus in Texas Gulf Sulphur from access to possession, it appeared that the "unfairness" element in securities fraud liability had become paramount. In fact, after the district

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4 Id. at 852. Eleven of the individual defendants were charged with having violated rule 10b-5 by purchasing TGS stock or calls thereon between November 12, 1963 and April 16, 1964. 258 F. Supp. at 281. Three of the individual defendants were charged with having violated the rule by tipping material nonpublic information. 401 F.2d at 839-41. The SEC complaint also charged that five of the individual defendants had accepted options to buy TGS stock on February 20, 1964 without disclosing material information known to them about the results of the exploratory drilling in contravention of the statute and the rule. Id. at 839-42.

In addition to seeking injunctive relief, the SEC sought rescission of the securities transactions of the individual defendants if they were found to have been conducted in violation of section 10(b) and rule 10b-5. Id. at 839.

9 See note 7 supra.

96 See note 76 and accompanying text supra. The district court in Texas Gulf Sulphur, applying the Cady, Roberts rationale, held that employers "who are in possession of material undisclosed information obtained in the course of their employment" are subject to the disclosure obligation of rule 10b-5. 258 F. Supp. at 279. This was the first time that rule 10b-5 was held to impose an affirmative duty to disclose on employees. See Note, Texas Gulf Sulphur: Its Holdings and Its Implications, 22 Vand. L. Rev. 359, 366 (1969).

97 401 F.2d at 849. It is not clear why the Texas Gulf Sulphur court chose to move to the more liberal "possession" test. It appears that the court was anticipating the question of whether "tippees" could be held liable for fraudulent nondisclosure under rule 10b-5, accord, Nathanson v. Weis, Voisin, Cannon, Inc., 325 F. Supp. 50, 54 (S.D.N.Y. 1971), since the access test could be unavailing where the defendant, a noninsider, trades on second-hand, or even more remote information, Bromberg, supra note 78, at 740, 747-49. The Texas Gulf Sulphur court, in fact, did declare that the conduct of the defendant's "tippees" was as "equally reprehensible" to that of the "tippers," 401 F.2d at 852-53, but since none of the tippees had been named as defendants, the court was not presented with the issue of whether trading by tippees on material inside information would violate rule 10b-5, id.
court decision in that case, one commentator noted that rule 10b-5 had been construed "so loosely that it is closer to unfairness than to what either lawyers or laymen usually think of as fraud." It seemed, moreover, that the courts might be more receptive to extending 10b-5 liability for nondisclosure to "outsiders" under the "possession" standard. Indeed, shortly after Texas Gulf Sulphur, 10b-5

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8 A. Bromberg, supra note 3, at § 1.1, quoted in SEC v. Great Amer. Indus., Inc., 407 F.2d 453, 462 (2d Cir. 1968) (Kaufman, J., concurring), cert. denied, 395 U.S. 920 (1969). The Texas Gulf Sulphur court's emphasis on the unfairness element was further evinced by its conclusion on when information becomes material. Rejecting the district court's "conservative" test for materiality, the court held that: "The basic test of materiality . . . is whether a reasonable man would attach importance [to the information] in determining his choice of action in the transaction in question." 401 F.2d at 849 (quoting List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1963), cert. denied, 382 U.S. 811 (1964)). The court's determination that information need not be "reasonably certain to have a substantial effect on the market price" to be material is of extreme significance, see 401 F.2d at 849, because as one commentator has stated: "Materiality is probably the most important element a plaintiff must plead and prove in a misrepresentation or nondisclosure case." Bromberg, Are There Limits to Rule 10b-5?, in Proceedings ABA National Institute, Revolution in Securities Regulation, 29 Bus. Law. 167 (Spec. Issue 1974). See generally Wiesen, Disclosure of Inside Information—Materiality and Texas Gulf Sulphur, 28 Md. L. Rev. 189 (1968).

The trend toward liberalizing the definition of materiality was continued by the Supreme Court in Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), wherein the Court stated that facts are material if "a reasonable investor might have considered them important in the making of [his] decision." 406 U.S. at 153-54. It is unclear, however, if the liberal standard of materiality enunciated in Affiliated Ute Citizens remains viable in light of the Court's subsequent decision in TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976). See 5 A. Jacobs, supra note 3, § 61.02[b][i] at 3-91 to 3-92. In TSC, the Court defined the standard of materiality under rule 14a-9 of the Exchange Act, stating that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in [reaching his decision]." 426 U.S. at 449. Courts after TSC have applied its materiality standard in 10b-5 cases. See, e.g., Zweig v. Hearst Corp., 594 F.2d 1261 (9th Cir. 1979); SEC v. Research Automation Corp., 585 F.2d 31 (2d Cir. 1978).

In SEC v. Great Amer. Indus., Inc., 407 F.2d 453 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 920 (1969), decided by the Second Circuit four months after Texas Gulf Sulphur, Judge Friendly, author of the majority opinion, stated that it "would be occupying new ground and would require most careful consideration" before the disclosure obligation of rule 10b-5 should be read as applying to persons other than insiders. 407 F.2d at 460. Judge Kaufman, concurring separately, however, stated that any claim that material facts were withheld in a transaction in connection with the sale or purchase of securities must be scrutinized with care, whether or not there would have been liability at common law for such a deed.

a court for the first time held that “tippees” in possession of material inside information with the knowledge that is not available to the public generally, must either disclose the information or refrain from trading. Until Chiarella, however, it was unclear to what extent the federal securities laws did in fact create a more far-reaching disclosure obligation than existed at common law.

Narrowing the Duty to Disclose: Chiarella v. United States

In Chiarella v. United States, the defendant, a financial printer, learned of several pending takeover bids while preparing documents for the acquiring corporations. Without disclosing his knowledge of the forthcoming takeovers, Chiarella purchased stock in each of the prospective target companies and then promptly sold the shares at a significant profit when the tender offers were made public. Chiarella’s trading activity eventually became the subject of an SEC investigation and, in 1977, Chiarella entered


100 SEC v. Shapiro, 349 F. Supp. 46, 53 (S.D.N.Y. 1972), aff’d, 494 F.2d 1301 (2d Cir. 1974). Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967), is sometimes cited as the first court decision to impose an affirmative duty to disclose on a “tippee.” The tippee in Ross was actually an employee, however, and the Ross court prefaced its holding primarily on the district court decision in Texas Gulf Sulphur, wherein the court held that employees are insiders under the Cady, Roberts test.

The SEC, a year before Shapiro, held that the tippee who has “reason to know” that the information he possesses emanates from a source within the issuer is subject to the disclosure obligation imposed by rule 10b-5. See In re Investors Mgmt. Co., 44 S.E.C. 633, 644 (1971). See generally Comment, Investors Management Company and Rule 10b-5 — The Tippee at Bay, 72 Colum. L. Rev. 545 (1972); Note, Investors Management: Institutional Investors as Tippees, 119 U. Pa. L. Rev. 502 (1971).

101 445 U.S. at 224.

into a consent decree in which he agreed to relinquish his profits\textsuperscript{103} to the sellers of the target company stock.\textsuperscript{104} He subsequently was indicted and convicted of the willful misuse of material nonpublic information in violation of section 10(b) and rule 10b-5.\textsuperscript{105} The United States Court of Appeals for the Second Circuit rejected Chiarella's argument that he was not subject to the disclosure obligation of an insider\textsuperscript{106} and affirmed his conviction,\textsuperscript{107} holding that the "disclose or refrain from trading" rule enunciated in \textit{Texas Gulf Sulphur} applied to "\textit{[a]nyone—corporate insider or not—} who regularly receives material nonpublic information."\textsuperscript{108}

\textsuperscript{104} 445 U.S. at 224.
\textsuperscript{105} Id. at 225.
\textsuperscript{106} 588 F.2d at 1364. Chiarella argued that he did not breach any duty of disclosure since he was neither "an 'insider' or a 'tippee' of an 'insider' of the target corporations whose shares he purchased." Brief for Petitioner at 24, 445 U.S. 222 (1980). In support of his argument, he pointed to the Second Circuit's decision in General Time Corp. v. Talley Indus., Inc., 403 F.2d 159 (2d Cir. 1968), \textit{cert. denied}, 393 U.S. 1026 (1969). Brief for Petitioner at 25-26, 445 U.S. 222 (1980). Holding that a tender offeror did not breach rule 10b-5 by purchasing shares of the target company stock without revealing his true intentions, the Second Circuit stated: "We know of no rule of law . . . that a purchaser of stock, who was not an 'insider' and had no fiduciary relation to a prospective seller, had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale." 403 F.2d at 164. \textit{Talley Industries} implied, therefore, that although material lies and half-truths would serve as a basis for violation of rule 10b-5, see L. Loss, \textit{supra} note 44, at 1445, pure nondisclosure of outside information would not, since there is nothing to trigger an obligation to divulge such information.
\textsuperscript{107} 588 F.2d at 1373. Chiarella was convicted under section 32(a) of the Exchange Act which imposes criminal liability on "[a]ny person who willfully violates any provision of [the Exchange Act] or any rule or regulation thereunder the violation of which is made unlawful . . . ." 15 U.S.C. § 78ff(a) (1976). Since no person, not even a corporate insider, had ever been held to have violated rule 10b-5 by trading on material nonpublic information which emanated from a source outside the issuer, Chiarella argued that his conviction deprived him of the fair notice requirement of the due process clause. 588 F.2d at 1369. The Second Circuit rejected this argument since other printers who had engaged in conduct identical to Chiarella's had previously consented to preliminary injunctions against them. \textit{Id.} at 1369 & n.17. \textit{See} note 102 \textit{supra}. Moreover, Chiarella's employer had posted numerous signs throughout his plant, warning employees that criminal liability could result from their personal use of confidential information learned by them in the course of their employment. 588 F.2d at 1369 & n.18. For a comprehensive discussion of the due process question presented in \textit{Chiarella}, see Deutsch, \textit{The New Deal and the Burger Court: The Significance of United States v. Chiarella}, 57 Tex. L. Rev. 965 (1979).
\textsuperscript{108} 588 F.2d at 1365. The Second Circuit found that Chiarella was a "market insider" because his position as a financial printer gave him "access on a regular basis to the most confidential information in the world of finance." \textit{Id.} As support for extending 10b-5's disclosure obligation to "market insiders," the court pointed to the concept of "quasi-insiders"
On writ of certiorari, the Supreme Court rejected the Second Circuit's "regular access" test and reversed Chiarella's conviction. Relying primarily on the SEC's decision in Cady, Roberts, the Court concluded that prior SEC and lower court decisions had recognized an affirmative disclosure obligation under rule 10b-5 where "a relationship of trust and confidence [existed] between parties to a transaction." The Court held, therefore, that "a duty to disclose under § 10(b) does not arise from the mere possession of non-public market information." Since Chiarella was neither an insider of the issuer nor a fiduciary to the selling

developed in the American Law Institute's proposed codification of the federal securities laws, see ALI Proposed Code, supra note 102, § 1603, comment 3(d). 588 F.2d at 1365-66. Under the ALI code, quasi-insiders would be subject to a duty of disclosure in "egregious" cases. See ALI Proposed Code, supra note 102, § 1603, comment 3(d). The Second Circuit believed Chiarella's conduct to be "sufficiently egregious" to give rise to a duty of disclosure under the ALI approach. 588 F.2d at 1366.

The court also drew support for its position by analogizing Chiarella's status as a "market insider" to the status of the two defendant bank employees in Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972). See 588 F.2d at 1369. In Affiliated Ute Citizens, a corporation was formed to manage the assets of the mixed-blood members of the Ute Indian Tribe. 406 U.S. at 136. Shares of capital stock were issued to each mixed-blood member, but deposited with a bank as transfer agent for the stock. Id. at 136-37. In order to sell their shares, therefore, the mixed-bloods had to deal through the bank. Id. at 145. Two assistant managers of the bank, while performing the functions of transfer agent, personally purchased shares without disclosing to the selling Indians that they were actively soliciting orders for the shares for the purpose of resale at a higher price. Id. at 146-48. The Supreme Court held that had the two employees merely acted as transfer agents, they would not have been subject to a duty of disclosure. Id. at 151-52. But, by additionally acting as "market markers," the Court concluded that the two employees had violated rule 10b-5 by failing to disclose that they were in a position to profit by reselling the shares at a higher price. Id. at 153.

109 445 U.S. at 231-32.
110 Id. at 237.
111 See notes 69-76 and accompanying text supra. The Court interpreted Cady, Roberts narrowly as recognizing "a relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation." 445 U.S. at 228.
112 445 U.S. at 230. The Court also relied on its prior decision in Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), 445 U.S. at 229-30; see note 108 supra, but unlike the Second Circuit, the Chiarella Court perceived the disclosure obligation of the defendant bank employees as arising from the trust and confidence reposed in them by the mixed-blood members of the Ute tribe. See 445 U.S. at 230.
113 Id. at 235. In rejecting the Second Circuit's regular access test, the Chiarella Court pointed out that "not every instance of financial unfairness constitutes fraudulent activity under § 10(b)." Id. at 232. Thus, the Court put a damper on the trend toward making the unfairness element the predominant factor underlying the 10b-5 disclosure obligation, see note 98 and accompanying text supra, as evidenced by its statement: "Neither the Congress nor the Commission has ever adopted a parity-of-information rule." 445 U.S. at 233.
shareholders, he had no obligation to reveal his knowledge of the impending takeovers and, thus, his silence was not violative of section 10(b).\textsuperscript{114}

By adopting this special relationship standard, the Court in \textit{Chiarella} rejected the trend in the lower federal courts expanding rule 10b-5’s duty of disclosure far beyond common-law parameters. Relying instead on the SEC’s twenty-year-old decision in \textit{Cady, Roberts}, the Court effectively ignored two decades of precedent construing the disclosure obligation under section 10(b).\textsuperscript{116} The “earthshaking” decision of \textit{Texas Gulf Sulphur}, which established the possession test for nondisclosure liability, was mentioned by the Court only as an example of “corporate insiders us[ing] undisclosed information for their own benefit.”\textsuperscript{116} It is not surprising, therefore, that the Court found the Second Circuit’s “regular receipt” test to be a “radical departure” from the special relationship standard which it announced.\textsuperscript{117}

It appears, moreover, that the \textit{Chiarella} Court’s reading of \textit{Cady, Roberts} was unduly narrow. The respondents in \textit{Cady, Roberts} were not held to a duty to disclose because of their special relationship to the buyers of Curtiss-Wright stock, but rather because they shared the responsibilities of insiders by virtue of their access to inside information.\textsuperscript{118} The Commission in \textit{Cady, Roberts} was also quick to point out that the “antifraud provisions are not intended as a specification of [what] constitute[s] fraud, but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors.”\textsuperscript{119} It is submitted

\textsuperscript{114} 445 U.S. at 232-33.

\textsuperscript{116} Justice Blackmun, in his dissent in \textit{Chiarella}, observed that the majority’s special relationship test placed the federal securities laws in the “rearguard” of the modern common-law trend “toward a more flexible, less formalistic understanding of the duty to disclose.” 445 U.S. at 247-48 (Blackmun, J., dissenting). Justice Blackmun was also highly critical of the majority’s restrictive interpretation of section 10(b), stating:

The Court continues to pursue a course, charted in certain recent decisions designed to transform § 10(b) from an intentionally elastic “catchall” provision to one that catches relatively little of the misbehavior that all too often makes investment in securities a needlessly risky business for the uninitiated investor.

445 U.S. at 246 (Blackmun, J., dissenting) (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)).

\textsuperscript{117} 445 U.S. at 229.

\textsuperscript{118} See id. at 233.

\textsuperscript{119} See \textit{In re Cady, Roberts & Co.}, 40 S.E.C. 907, 912 (1961); note 111 supra.

\textsuperscript{119} 40 S.E.C. at 911. Professor Cary, commenting later on the \textit{Cady, Roberts} decision, stated that it would be an “illusory quest” to ask the SEC to define fraud. Symposium, \textit{Insider Trading in Stocks}, 21 Bus. Law. 1009, 1012 (1966); cf. A.T. Brod & Co. v. Perlow,
that the Chiarella Court overlooked this aspect of Cady, Roberts when it observed that the description of section 10(b) as a "catch-all" does not alter the fact that "what it catches must be fraud."\textsuperscript{120}

Regardless of the merit of the Supreme Court's special relationship test,\textsuperscript{121} Chiarella may impede the effective enforcement of rule 10b-5 antifraud provisions in two significant ways.\textsuperscript{122} By imposing a duty only when there exists a relation of trust and confidence between buyer and seller, Chiarella has restricted the potential defendants as to whom mere silence is actionable under the rule.\textsuperscript{123} Furthermore, the Supreme Court also may have weakened the power of the SEC to combat insider trading on the national securities markets.\textsuperscript{124} If, as suggested by the Court, however, 10b-5 may be breached by trading on the basis of converted, nonpublic information,\textsuperscript{125} then the impediments raised by the Court's special

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\textsuperscript{120} 445 U.S. at 234-35.
\textsuperscript{121} Chief Justice Burger and Justice Brennan agreed with the Chiarella majority that the mere possession of nonpublic information does not give rise to a duty to disclose, but both believed that a relationship of trust and confidence between buyer and seller was not necessary to establish a duty of disclosure. \textit{Id.} at 239 (Brennan, J., concurring), 243 n.4 (Burger, C.J., dissenting).

\textsuperscript{122} Except for the intent and burden of proof issues, civil and criminal liability for breach of section 10(b) and rule 10b-5 are "coextensive." \textit{See} United States v. Charnay, 537 F.2d 341, 348 (9th Cir.), \textit{cert. denied}, 429 U.S. 1000 (1976); 5B A. Jacobs, \textit{supra} note 3, § 263, at 11-289. Thus, although Chiarella was a criminal case, its implications for 10b-5's affirmative duty of disclosure are applicable to SEC actions for injunctive relief and for private actions for damages.

\textsuperscript{123} Certainly, under the special relationship standard of Chiarella, the protection of 10b-5 is unavailable in any pure nondisclosure case involving transactions by an outsider over a national securities exchange. Moreover, as Justice Blackmun observed in his dissent, \textit{see} 445 U.S. at 246 n.1 (Blackmun, J., dissenting), if the special relationship between the parties must be established directly, it will be difficult to establish a breach of rule 10b-5 by tippees trading on material inside information. The Chiarella Court's reliance on Cady, Roberts, however, in which the respondents were actually tippees, implies that the requisite relationship of trust and confidence can be satisfied derivatively through a fiduciary or an officer or director of the issuer. The SEC has espoused this view subsequent to Chiarella. \textit{See} SEC v. Lerner, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,334 (D.D.C. 1980); Marcus, Tax Shelter, Insider Suits Filed Against Law Firms, Nat'l L.J., Apr. 14, 1980, at 2, col. 3. The remote tippee who trades on material inside information may, therefore, still be subject to SEC sanctions and answerable in damages to private investors as well.

\textsuperscript{124} \textit{See} notes 130-134 and accompanying text infra.
\textsuperscript{125} \textit{See} 445 U.S. at 235-36. Four of the Justices in Chiarella expressed the belief that Chiarella, by trading on misappropriated information, had violated rule 10b-5 by breaching a duty of silence owed to the owner of the information. \textit{See} 445 U.S. at 239 (Brennan, J., concurring); \textit{id.} at 240 (Burger, C.J., dissenting); \textit{id.} at 245 (Blackmun & Marshall J.J., dis-
relationship test will be substantially mitigated.\textsuperscript{128} What follows is an analysis of this conversion theory of liability and an examination of the impact of \textit{Chiarella} on the implied right of action under section 10(b) and on the enforcement powers of the SEC.

\textit{Trading on Misappropriated Nonpublic Information}

The Supreme Court declined to rule on an alternative theory of liability, based on the unauthorized use of misappropriated information, that may ameliorate somewhat the restrictive rule of \textit{Chiarella}.\textsuperscript{127} The rationale of this conversion theory is that \textit{Chiarella} breached a duty of silence owed to the acquiring corporations when he converted confidential information obtained in the course of his work as a printer.\textsuperscript{128} The Second Circuit had reasoned that this fraud on the customers of \textit{Chiarella}'s employer was "in connection with the purchase or sale" of securities and, therefore, violated rule 10b-5.\textsuperscript{129} The conversion theory is fraught with theoretical and practical difficulties, however, and is not entirely consistent with 10b-5 precedent.

First, while the conversion theory may create some basis for imposing liability on wrongdoing "outsiders," it provides no remedy in situations where a noninsider trades on material nonpublic information that has been obtained legally. For example, large institutional investors commonly trade for their customers' accounts on the basis of information that another institutional investor is planning to purchase or sell a large block of securities.\textsuperscript{130} Although

\textsuperscript{128} See \textit{Top Court Limits View Involving 'Insider Trading'}, Wall St. J., Mar. 19, 1980, at 12, col. 3.

\textsuperscript{129} See note 125 supra.

\textsuperscript{130} Chief Justice Burger, the leading exponent for the Court on the misappropriation theory, perceived the conversion of nonpublic information as giving rise to a duty of disclosure, rather than a duty of silence. See 445 U.S. at 240 (Burger, C.J., dissenting). \textit{But see id. at 238} (Stevens, J., concurring). If the duty is one of disclosure, however, the question arises as to whom the duty is owed — to the owner of the information or to investors generally? Chief Justice Burger's dissent is silent on this point.

\textsuperscript{131} United States v. \textit{Chiarella}, 588 F.2d at 1388 n.14.

\textsuperscript{130} Securities trading by institutional investors is of startling dimension. According to the SEC, institutional investors purchased $56.7 billion and sold $46.5 billion of common stock in 1979 [\textit{Current Transfer Binder}] SEC. REG. & L. REP. (BNA) No. 554, at A-18 (May
the informational advantage of the institutional investor may be unfair, and its trading may not be justified by any legitimate business purpose, it will not be liable for nondisclosure under rule 10b-5 on a conversion theory. Moreover, there is no disclosure obligation under Chiarella's special relationship test and, hence, such conduct would not result in a breach of the rule.\textsuperscript{131}

Additionally, a conversion theory of liability is inconsistent with decisions imposing liability on outsiders for misuse of market information despite the absence of a conversion. In the typical "scalping" case,\textsuperscript{132} for instance, a financial columnist publishes a favorable report on a security and recommends its purchase without disclosing his recent prior purchases of the security. After publication of his report precipitates a rise in the price of the security, he sells his shares at a profit.\textsuperscript{133} Prior to Chiarella, this activity had been held violative of rule 10b-5.\textsuperscript{134} After Chiarella, however, it is unclear whether such activity could result in a breach of the rule, since the columnist is neither an insider, nor a fiduciary of those from whom he purchased. Furthermore, no misappropriated information is involved in the transaction.

Finally, a conversion theory of liability under rule 10b-5 would


\textsuperscript{132} Scalping has been defined as "the purchase of securities by a person in a position to influence others by his recommendation or favorable commentary on that security, the recommendation of that security to investors, and the sale of that security after capital appreciation." Peskind, \textit{Regulation of the Financial Press: A New Dimension to Section 10(b) and Rule 10b-5}, 14 St. Louis U.L.J. 80, 81 (1969); see, e.g., SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).


\textsuperscript{134} E.g., Zweig v. Hearst Corp., 594 F.2d 1261 (9th Cir. 1969). In Zweig, the Ninth Circuit held that scalping by a financial columnist "violated Section 10(b) and Rule 10b-5 just as corporate insiders do when they withhold material facts about a corporation's prospects while trading in its stock." \textit{Id.} at 1267 (citing the Second Circuit's decision in United States v. Chiarella, 588 F.2d 1358 (2d Cir. 1978)). The Zweig court relied heavily on the Supreme Court's decision in SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963), wherein the Court held that scalping by an investment advisor constituted a violation of section 206 of the Investment Advisors Act of 1940, 15 U.S.C. § 80b-6 (1976), 375 U.S. at 183. As pointed out by one commentator, however, unlike the investment advisor, a financial columnist is not a fiduciary. See Peskind, \textit{supra} note 132, at 85-96. See generally Note, \textit{A Financial Columnist's Duty to the Market Under Rule 10b-5: Civil Damages For Trading on a Misleading Investment Recommendation}, 26 Wayne L. Rev. 1021 (1980).
institutionalize the distinction between "inside" information derived from the issuer and "outside" information generated by sources outside the issuer. In practice and effect, this is a distinction without a difference.\textsuperscript{135} As the Second Circuit in \textit{Chiarella} noted, "From the point of view of a shareholder who sells his stock on the day before the price jumps sharply upward, it matters little whether the cause of the rise was news of an ore strike . . . or, as here, the announcement of a tender offer."\textsuperscript{136} The Supreme Court's approach, however, has forced such artificial distinctions.

\textbf{The Effect of \textit{Chiarella} on the Private Right of Action and on the SEC's Enforcement Powers}

The pre-\textit{Chiarella} trend in the lower courts toward expansion of 10b-5's disclosure obligation coincided with a relaxation of the causation element of the nondisclosure cause of action. Pure nondisclosure of material nonpublic information had only recently been recognized as a basis for civil liability for damages.\textsuperscript{137} Histori-

\begin{itemize}
\item \textsuperscript{135} The American Law Institute has emphatically stated that there is no basis for distinguishing between "inside" and "market" information:
\begin{quote}
So far as an "insider's" use of \textit{market information} is concerned, there is no reason in either principle or the case law to distinguish . . . between material information that is intrinsic to the company . . . and market information that will not affect the company's assets or earning power . . . .
\end{quote}
\item \textsuperscript{136} United States v. \textit{Chiarella}, 588 F.2d at 1365 n.8.
\item \textsuperscript{137} Although there had been dicta to the effect that pure nondisclosure could give rise to a private action for damages, \textit{see} List v. Fashion Park, Inc., 340 F.2d 457, 461-62 (2d Cir. 1965), \textit{cert. denied}, 382 U.S. 811 (1965), all of the pre-1969 cases which recognized a private cause of action for fraudulent nondisclosure involved either a face-to-face transaction or some element of misrepresentation. \textit{See}, \textit{e.g.}, Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962)(manipulative activity conducted by defendants); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951)(written offer made by defendants omitting critical facts); Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa.), \textit{modified}, 83 F. Supp. 613 (E.D. Pa. 1947)(express misrepresentations made by defendants). The first decision to recognize pure silence as a basis for a private action for damages was \textit{Astor v. Texas Gulf Sulphur Co.}, 306 F. Supp. 1333 (S.D.N.Y. 1969), one of the more than one hundred civil actions seeking damages from the Texas Gulf Sulphur company for issuing the misleading press release and from the individual defendants for trading on inside information, \textit{see} Ruder, \textit{supra} note 99, at n.25. The \textit{Astor} plaintiffs were primarily former shareholders in TGS who sold shares or calls on TGS stock between November 12, 1963 and April 12, 1964, the date the misleading press release was issued. \textit{Id.} at 1337. They brought suit against many of the same defendants named in the enforcement action brought by the SEC, \textit{see} note 94 and accompanying text \textit{supra}, alleging that they would not have sold had they known of the material information which the defendants failed to disclose. 306 F. Supp. at 1337. The defendants moved for summary judgment on the ground that no private action
\end{itemize}
cally, actionable nondisclosure could be established in a private suit for damages, as distinguished from an SEC enforcement proceeding, only upon affirmative proof that the plaintiff's injury was caused by the defendant's conduct.\textsuperscript{138} Obviously, where the defendant's unlawful transactions were effected on a national securities exchange, the plaintiff could not establish that he was in privity\textsuperscript{139} with the defendant, nor could he establish literal reliance on the defendant's conduct.\textsuperscript{140} With the acknowledgement by the Texas Gulf Sulphur court of the rule 10b-5 purpose to "insure fairness in securities transactions generally, whether conducted face-to-face, over the counter, or on the exchanges,"\textsuperscript{141} it was finally established

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\textsuperscript{138} See generally Note, Civil Liability Under Section 10B and Rule 10B-5: A Suggestion for Replacing the Doctrine of Privity, 74 YALE L.J. 658, 674-82 (1965).

\textsuperscript{139} The seminal decisions under rule 10b-5 had required some semblance of privity between the buyer and the seller to establish causation in a nondisclosure case. See, e.g., Meisel v. North Jersey Trust Co., 218 F. Supp. 274 (S.D.N.Y. 1963); Donovan, Inc. v. Taylor, 136 F. Supp. 522 (N.D. Cal. 1955); Joseph v. Farnsworth Radio & Television Corp., 59 F. Supp. 701 (S.D.N.Y. 1951), aff'd per curiam, 199 F.2d 583 (2d Cir. 1952). See generally 5 A. Jacob, supra note 3, § 62; 3 L. Loss, supra note 44, at 1767-71. Although the requirement of privity in a private action for damages under rule 10b-5 has been criticized, see, e.g., 3 L. Loss, supra note 44, at 1468; 63 COLUM. L. REV. 934, 941 (1963), at least one commentator has argued that the privity requirement is necessary to prevent liability for violation of rule 10b-5 from becoming open-ended. See Ruder, supra note 99, at 446.


\textsuperscript{141} SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969); see Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 353
that "causation in fact" could be proved—even in the absence of privity or proof of reliance—if the undisclosed information was material. Consequently, with the causation requirement relaxed considerably, the plaintiff's cause of action for violation of rule 10b-5 was stated by a mere showing that the defendant, with scienter and prior to trading, failed to disclose material inside information which he knew was not publicly available, and that the plaintiff's trading was contemporaneous with that of the defendant.

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145 See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 240 (2d Cir. 1974). But see Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977). Shapiro is representative of the evolution that has occurred in civil liability for trading on material nonpublic information. It seems that Merrill Lynch, by virtue of its position as prospective managing underwriter for Douglas Aircraft Company, learned that Douglas' earnings for the first five months of its fiscal year were lower than had previously been expected. 495 F.2d at 232. Before this information was publicly disclosed, certain officers, directors and employees of Merrill Lynch leaked the news of Douglas' adverse earnings report to several of its customers. Id. Although the "tippees" knew or should have known that the information was not yet public, they nevertheless sold several thousand shares of Douglas stock through the New York Stock Exchange. Id. The Shapiro plaintiffs, who purchased their shares of Douglas stock during the same time period in which the tippees sold, id. at 232-33, brought suit against Merrill Lynch and several of its officers, employees, and directors for tipping material inside information, and against the Merrill Lynch customers for selling Douglas stock while in possession of material nonpublic information which had been leaked to them by Merrill Lynch. None of the Shapiro defendants was an insider in the traditional sense, see note 7 and accompanying text supra; nor did the alleged fraudulent activity involve any element of manipulation, misrepresentation, or omission, see note 137 supra; nor was there any semblance of privity between the parties, see note 139 supra; and since the defendants sold on a national securities exchange, there was no actual reliance by the plaintiffs on the defendants' activity, see note 140 supra. Moreover, there was no showing that the shares purchased by the plaintiffs were the same specific shares sold by the defendants. 495 F.2d at 233. Although each of the foregoing elements had been held at one time to be sufficient to defeat a cause of action for damages, the Second Circuit held, on the basis of the Texas Gulf Sulphur and Affiliated Ute decisions, that the defendants would be liable in damages for violating rule 10b-5 should the plaintiffs succeed at trial in proving the facts alleged in their complaint. Id. at 241.

Fridrich, like Shapiro, was another action for damages based on pure nondisclosure,
It is submitted that the Chiarella Court, in recognition of the enormous liability which could result from trading on material nonpublic information, was actually attempting to retard further expansion of civil liability under rule 10b-5. While the Court’s

wherein the defendants, using material nonpublic information, purchased shares in an impersonal market. 542 F.2d at 313. It was also “undisputed” that the plaintiffs had not sold their shares to the defendants. Id. Although the district court held that the defendants were liable in damages for violating rule 10b-5, id. at 312-13, the Sixth Circuit reversed, holding that the defendants’ conduct did not cause the plaintiffs’ injury. Id. at 318. In reaching its conclusion, the Sixth Circuit expressly refused to follow the Second Circuit’s rationale in Shapiro, id., and held that the Supreme Court’s decision in Affiliated Ute, see text accompanying notes 141-142 supra, was limited to its “circumstances,” since Affiliated Ute involved a scheme to defraud as well as nondisclosure. 542 F.2d at 319-20. See generally Rapp, Fridrich v. Bradford and the Scope of Insider Trading Liability Under Rule 10b-5, 38 Ohio St. L.J. 67 (1977); Comment, Damages to Uninformed Traders for Insider Trading on Impersonal Exchanges, 74 Colum. L. Rev. 299 (1974).

146 Cf. Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (absent any misrepresentation or nondisclosure, mere breach of fiduciary duty by majority shareholders does not constitute violation of rule 10b-5); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (absent some allegation of scienter, no civil cause of action for money damages will lie under section 10(b) and rule 10b-5); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1978) (offeree who was neither purchaser nor seller has no standing to maintain cause of action for money damages for violation of rule 10b-5). Although indications are that Congress never intended the implied private right of action under section 10(b), Ruder, Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?, 57 Nw. U.L. Rev. 627, 643 (1963); DeLancey, Rule 10b-5—A Recent Profile, 25 Bus. Law. 1355, 1355 (1970), such a right is firmly established. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477 (1977); Affiliated Ute Citizens v. United States, 406 U.S. 128, 150-54 (1972); Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 18 n.9 (1971). In recognizing that this right has been implied by the lower courts, the Supreme Court has not been insensitive to the substantial civil liability which may result from violation of the rule. In fact, its decisions in Hochfelder, Santa Fe, and Blue Chip Stamps may be read fairly as attempts to curtail the private right of action for violation of rule 10b-5. See Lowenfels, Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings, 65 Geo. L.J. 891, 892, 900-01 & n.57 (1977); Whittaker & Rotch, The Supreme Court and the Counter-Revolution in Securities Regulation, 30 Ala. L. Rev. 335, 383 (1979).

In Blue Chip Stamps, the Court severely restricted the class of plaintiffs who may sue for damages for violation of rule 10b-5 to actual purchasers or sellers of securities. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 731. Thus, the Court held that an offeree who was discouraged from purchasing securities by an overly pessimistic prospectus had no standing to maintain an action against the issuer for money damages under the rule. Id. at 727. Similarly, in Santa Fe, the Court held that in the absence of any misrepresentation or nondisclosure, minority shareholders had no cause of action under 10b-5 for injury resulting from the majority shareholders’ breach of fiduciary duty. Santa Fe Indus., Inc. v. Green, 430 U.S. at 471-72. Thus, Santa Fe further restricted the private cause of action under section 10(b) and rule 10b-5 to those plaintiffs whose cause of action was based, not on fraud generally, but on some material misrepresentation or failure to disclose. See Lowenfels, supra, at 900-01 n.57. It is submitted that the Court’s decision in Chiarella is still another attempt by the Court to restrict the class of plaintiffs who may sue for violation of rule 10b-5. In his concurrence in Blue Chip Stamps, Justice Powell, author of the majority opinion in Chiarella, noted that allowing offerees to sue for violation of rule 10b-5 would inevitably...
decision implies that a private remedy for fraudulent nondisclosure still exists if a aggrieved party apparently has no cause of action in the absence of any relationship of trust and confidence. To a party injured by a failure to disclose material nonpublic information, however, it makes no difference whether the information was derived from an inside or outside source. Any trader with a monopoly on access to material nonpublic information should not be permitted to exploit his informational advantage to the detriment of the less informed. The Chiarella rule nonetheless has deprived some potential plaintiffs of a private remedy and is indefensible in light of the purpose of the private right of action under section 10(b).

Moreover, a civil action for damages against an outsider for violation of rule 10b-5 may not lie even if the liability were predicated on a conversion theory. On the facts of Chiarella, for example, the fraud was perpetrated on the acquiring corporations,

lead to the subjective inquiry: "Would I have purchased this particular security at the time it was offered if I had known the correct facts?" Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 757 (Powell, J., concurring). It is this type of inquiry, however, which is presented in any pure nondisclosure case. If other members of the Court adopt Justice Powell's position—if they have not already by espousing the special relationship test in Chiarella—the private cause of action under rule 10b-5 for trading on material nonpublic information over a national securities exchange may be judicially legislated out of existence.

See text accompanying note 136 supra.

Brudney, supra note 81, at 357; see Chiarella v. United States, 445 U.S. at 251 (Blackmun, J., dissenting). Since the courts have not drawn distinctions between insiders and outsiders in misrepresentation cases, 3 L. Loss, supra note 44, at 1445, and since no distinction is made in the language of either section 10(b), see note 2 supra, or rule 10b-5, see note 3 supra, it appears inconsistent to make such distinctions in nondisclosure cases. Moreover, with the vast majority of securities transactions conducted on the national securities exchanges, it is unrealistic to premise 10b-5's duty to disclose on concepts of fiduciary relationships between the parties. Rather, as Professor Brudney has observed:

[T]he [disclose-or-refrain] rule rests on a broader premise. Another—indeed the essential—element which makes an informational advantage usable by those who possess it in dealing with those who do not is the inability of the latter to overcome it lawfully, no matter how great may be their diligence or large their resources.

Brudney, supra note 81, at 354. Justice Blackmun apparently subscribes to Professor Brudney's "inerodable-informational-advantage" theory, for in his dissent in Chiarella he states that rule 10b-5 should be read to prevent "persons having access to confidential material information that is not legally available to others... from engaging in schemes to exploit their structural informational advantage through trading in affected securities." Chiarella v. United States, 445 U.S. at 251 (Blackmun, J., dissenting).

See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228, 235 (2d Cir. 1974); Fratt v. Robinson, 203 F.2d 627, 632 & n.16 (9th Cir. 1953); Baird v. Franklin, 141 F.2d 238, 244-45 (2d Cir. 1944) (Clark, J., dissenting).
rather than on the sellers of the target company securities. Since the defrauded parties were neither buyers nor sellers, they probably lacked standing under the rule to bring a private action for damages. Thus, while the conversion theory may be useful in criminal prosecutions and SEC enforcement proceedings, it will be of little help to private investors—the persons the federal securities laws were intended to protect.

Unlike the Supreme Court's previous attempts to limit the implied right of action under rule 10b-5, the rule announced in Chiarella is not confined to civil actions for violation of the rule. By seeking to restrict the private cause of action, the Court may have diminished the power of the SEC to effectively control insider trading on the national securities markets. Even assuming that a conversion theory of liability is valid, certain market professionals could trade on nonpublic market information without violating rule 10b-5, since their information is obtained legally and they stand in no special relationship to the other party to the transaction. Hence, such conduct is not within the jurisdiction of the SEC. If the Commission is to thwart such activity, additional rulemaking or Congressional legislation must be forthcoming.

CONCLUSION

Unfortunately, Chiarella v. United States was a difficult case. No insider had ever been prosecuted criminally for trading on material inside information, let alone someone in such a tenuous

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152 See notes 125-129 and accompanying text supra.
153 See note 146 supra.
154 See note 122 supra.
155 See note 146 supra.
156 See notes 25 & 27 and accompanying text supra.
157 See notes 130-134 and accompanying text supra.
158 The SEC has recently adopted rule 14e-3, promulgated under section 14(e) of the 34 Act, 15 U.S.C. § 78n(e) (1976 & Supp. III 1979), which imposes a disclose-or-refrain rule for any person who obtains inside information on a tender offer from certain specified sources. SEC Exch. Act Rel. No. 17120, Sept. 4, 1980, reprinted in [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) § 82,646. Had rule 14e-3 been in effect at the time Chiarella transacted on the basis of undisclosed information, his activity would have been covered by the rule. See id.
position to the issuer as Vincent Chiarella. Since the Supreme Court decided the case on the basis of an absence of a duty to disclose, the due process questions were never presented.\textsuperscript{160} It may have been more appropriate to have decided the case on this latter basis, however, than to have curbed the SEC's authority to deal with developing forms of illegality in the trading of securities. Indeed, perhaps the greatest virtue of rule 10b-5 has been its adaptability to encompass the "infinite varieties of securities fraud."

It is easy to criticize the amount of judicial legislation that has occurred under section 10(b) and rule 10b-5. Yet, when Congress opted against enacting a narrowly circumscribed antifraud provision, it was aware of the ingenuity of the securities bar.\textsuperscript{161} Moreover, the antifraud provisions of the American Law Institute's proposed \textit{Federal Securities Code}\textsuperscript{162} in large part mirror rule 10b-5. Indeed, the drafters of the proposed \textit{Code} recognized that limitations on trading by outsiders on material nonpublic information "must be left to further judicial development."\textsuperscript{163} The primary consequence of \textit{Chiarella}, however, is to seriously constrain the ability of the courts to treat nondisclosure situations. The Supreme Court has thus placed the burden on Congress to draft a more specific enactment if these new informational abuses are to be curtailed.\textsuperscript{164} In so doing, the Court is forcing the Congress to define "fraud," the very problem Congress chose to avoid when it enacted section 10(b) of the Securities Exchange Act of 1934.

\textit{Frank F. Coulom, Jr.}


\textsuperscript{161} See Charles Hughes & Co. \textit{v.} SEC, 139 F.2d 434, 439 (2d Cir. 1943); Archer \textit{v.} SEC, 133 F.2d 795, 803 (8th Cir. 1943), \textit{cert. denied}, 319 U.S. 767 (1943).

\textsuperscript{162} See \textit{ALI Proposed Code, supra} note 102, §§ 1602-1603. The SEC and the American Law Institute have recently reached agreement on certain revisions in the proposed \textit{Code}, and a draft bill is expected to be introduced in Congress in the near future. SEC Exch. Act Rel. No. 17153, Sept. 18, 1980, \textit{reprinted in part in} [Current Transfer Binder] \textit{Fed. Sec. L. Rep.} (CCH) ¶ 82,655.

\textsuperscript{163} See \textit{ALI Proposed Code, supra} note 102, § 1603, comment 3(d).

\textsuperscript{164} See also \textit{Ernst \& Ernst \textit{v.} Hochfelder}, 425 U.S. 185, 218 (1976) (Blackmun, J., dissenting).