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Securities Regulations--Fraud--Broker's Use of "Insider" Information Without Disclosure Held Violation of SEA (In the Matter of Cady, Roberts & Co., CCH Fed. Sec. L. Rep. (2d ed.) ¶ 76803 (November 8, 1961))

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SECURITIES REGULATIONS — FRAUD — BROKER'S USE OF "INSIDER" INFORMATION WITHOUT DISCLOSURE HELD VIOLATION OF SEA. — Respondent was a selling broker and partner in a firm registered with the Securities and Exchange Commission. The firm employed a registered representative who was also a director of Curtiss-Wright Corporation. The board of directors of Curtiss-Wright approved a reduction in the company's last quarterly dividend, but before this information became public respondent learned of the board's action through the representative-director who supplied the information without knowledge that it had not been published. Respondent immediately entered sell orders on behalf of a number of the firm's clients, without disclosing the impending dividend reduction. In proceedings to determine whether the anti-fraud provisions of the securities acts had been violated, the Commission *held* that respondent had breached the duty of disclosure incorporated in Section 10(b) of the Securities Exchange Act, 17(a) of the Securities Act and Rule X-10B-5 of the Commission. *In the Matter of Cady, Roberts & Co.*, CCH FED. SEC. L. REP. (2d ed.) ¶ 76803 (November 8, 1961).

Fraudulent practices resorted to in the purchase and sale of corporate securities give rise to a common-law action for deceit.[1] However, as in any common-law fraud action, it is necessary in order to establish liability to prove: conscious misrepresentation of a material fact; that it was made to induce reliance by plaintiff; that there was an actual reliance; and, consequent damage.[2] Where a fraud action is based on a failure to make known certain facts, as opposed to active misrepresentation, a defendant's liability is contingent upon the existence of a duty of disclosure arising from the specific relationship of the parties or other extrinsic factors sufficient to require a high degree of candor and frankness.[3] Where such a duty of disclosure does not exist, and in the absence of positive misrepresentation, a transaction will fall within the scope of the doctrine of *caveat emptor*.[4]

The application of these common-law principles to corporate insiders has not been uniform. A majority of jurisdictions have taken the position that the fiduciary duty of insiders is owed to the corporate entity as a whole, as opposed to individual shareholders, with the result that in these states directors and controlling shareholders may purchase and sell to minority holders without making any disclosure of "inside" information.[5] Some jurisdictions,

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1 See LOSS, SECURITIES REGULATION 812-23 (1951).
2 *Id.* at 813.
3 *Id.* at 816.
4 *Ibid.*
5 See Note, 39 CALIF. L. REV. 429, 430 (1951).

on the other hand, have adopted the view that the basic responsibilities of corporate fiduciaries are owed to the shareholders as such, so that an insider who exploits confidential corporate information in dealing with shareholders of the corporation is guilty of a breach of trust.[6] A third approach, although concurring in the majority attitude regarding the fiduciary obligations of insiders, imposes a duty of disclosure in situations involving "special circumstances." [7]

Federal statutory provisions relating to fraud in securities transactions are embodied in Section 10(b) of the Securities Exchange Act of 1934 [8] and Section 17(a) of the Securities Act of 1933,[9] both of which contain general prohibitions against the use of fraudulent practices. Section 10(b) is phrased in terms of "any manipulative or deceptive device or contrivance"; section 17(a) and rule X-10B-5 promulgated by the SEC,[10] refer to "any device, scheme, or artifice to defraud" and "fraud or deceit upon any person." Whether or not under any particular circumstances there exists a statutory duty of disclosure must be determined from this broad language.

Pursuant to these sections, the courts have required disclosure by corporate insiders dealing with minority shareholders [11] and by stockbrokers in transactions with or on behalf of clients.[12] With regard to the former, the so-called "minority" common-law view seems to have been read into the securities laws. Thus, for example, it was stated in *Speed v. Transamerica Corp.*: "The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority stockholders." [13] In the broker cases the courts have based their conclusion on the fiduciary relationship

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[6] *Ibid.*

[7] Strong v. Repide, 213 U.S. 419 (1909). See also Note, *supra* note 5, at 430-31.

[8] Securities Exchange Act § 10(b), 48 Stat. 891 (1934), 15 U.S.C. § 78j(b) (1958). Section 10(b) applies where there is "use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange. . . ." *Ibid.*

[9] Securities Act § 17(a), 48 Stat. 84 (1933), 15 U.S.C. § 77q(a) (1958). The provisions of this section regulate the sale of securities "in interstate commerce or by the use of the mails, directly or indirectly. . . ." *Ibid.*

[10] 17 C.F.R. § 240.10B-5 (1949).

[11] See, *e.g.*, Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (D. Del. 1951); Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa. 1947). See Comment, 32 TEXAS L. REV. 198, 200 (1953).

[12] See, *e.g.*, Smith v. Bear, 237 F.2d 79, 87-88 (2d Cir. 1956); Hawkins v. Merrill, Lynch, Pierce, Fenner & Beane, 85 F. Supp. 104, 122 (W.D. Ark. 1949). In the present proceeding the transaction involved was entered into on behalf of clients but there was no element of self-gain as in the above cases.

[13] Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (D. Del. 1951).

of trust and confidence which exists between a broker and his client.[14]

In the proceeding under discussion, the SEC took up the question of whether the statutory duty of disclosure under 10(b) and 17(a) extends beyond these groups and concluded that it does. The finding of the Commission was based mainly on two grounds:

[1] "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," [15] and

[2] "the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing." [16]

The view adopted seems to be that there is a basic unfairness in the use by one party, to the disadvantage of another, of corporate information never intended for the private gain of individuals. Whereas the common law would look to some fiduciary relationship in ascertaining the existence of a duty of disclosure, the Commission apparently conceives of a statutory duty of disclosure inherent in "inside" corporate information *as such,* the use of which by any individual, without disclosure, is presumptively tortious.

In addition, the ruling suggests that respondent, under the facts presented, could be held to have violated common-law principles. Despite the fact that such a conclusion was not necessary to the final result, some reliance was placed on this approach as added support for the actual holding. At common law, complicity by a third party in the breach of a fiduciary's duty renders the third party liable to the fiduciary's beneficiary. The Commission presupposes the existence of a duty of disclosure on the part of the firm's representative-director. Although it is not made clear to whom such duty was owed, the public in general would seem, from the opinion as a whole, the most logical choice. According to this reasoning, respondent, in making use of inside corporate information without disclosure, cooperated in a breach of the director's duty to the public. The use of this information by respondent with knowledge that it had not been released to the public apparently was considered by the Commission as constituting "complicity," despite the fact that the representative-director concededly acted in complete good faith and may not himself have been guilty of any breach of trust.[17]

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[14] See Norris & Hirshberg, Inc., v. SEC, 177 F.2d 228, 231 (D.C. Cir. 1949); Hughes v. SEC, 174 F.2d 969, 976 (D.C. Cir. 1949).

[15] In the Matter of Cady, Roberts & Co., CCH FED. SEC. L. REP. (2d ed.) ¶ 76803, at 81017 (November 8, 1961).

[16] *Ibid.*

[17] *Ibid.* See RESTATEMENT, RESTITUTION § 201(2) (1937).

In a number of other proceedings described as "analogous" by the Commission[18] and in which brokers had been subjected to an obligation of disclosing inside corporate information, the brokers had acted as agents for insiders with the view of realizing profits for themselves.[19] In the present matter there was clearly no such scheme between the accused broker and the insider-director and no profits were realized by either party. Rather, the broker had acted to protect the accounts of his clients and merely did, it was contended, what his obligation of loyalty required. The Commission took the position that no duty to one's clients justifies resort to unfair methods in promoting their interests.[20]

It seems clear that the *general* scope of the fraud provisions incorporated in the federal securities acts is considerably broader than common-law concepts of fraud.[21] A number of common-law requirements are dispensed with.[22] However, the extent of the *duty of disclosure* embodied in these provisions has, as a separate matter, remained poorly defined.[23] The need for clarification, in this regard, is accentuated by what, until now, has appeared to be a limitation of liability for nondisclosure to corporate insiders and stockbrokers violating some clearly defined duty toward their clients. It would seem from both the broad statutory terminology involved, and the tenor of decisions construing it, that the disclosure requirements of 10(b) and 17(a), if not as broad as the general scope of the fraud provisions, are at least as extensive as those existing at common law. But the crucial point to be determined is to what extent, if any, the federal securities acts go beyond the common law or, in other words, whether or not they create a duty of disclosure more imperative than any existing prior to their enactment. The SEC has decided that they do. The ultimate answer must be given by Congress or the courts.

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18 In the Matter of Cady, Roberts & Co., *supra* note 15, at 81017.

19 See, *e.g.*, In the Matter of Hughes & Treat, 22 S.E.C. 623 (1946); In the Matter of R. D. Bayly & Co., 19 S.E.C. 773 (1945); In the Matter of Hay, 19 S.E.C. 397 (1945).

20 In the Matter of Cady, Roberts & Co., *supra* note 15, at 81020.

21 See, *e.g.*, Norris & Hirshberg, Inc. v. SEC, 177 F.2d 228, 233 (D.C. Cir. 1949); Hawkins v. Merrill, Lynch, Pierce, Fenner & Beane, *supra* note 12.

22 See Loss, Securities Regulation 818-23 (1951). For example, under Section 17(a)(1) of the Securities Act it is not necessary for the Commission to prove actual loss in order to establish fraud. *Id.* at 819.

23 In Connelly v. Balkwill, 174 F. Supp. 49, 59 (N.D. Ohio 1959), the court held that the duty of disclosure under § 10(b) was no more extensive than that required by the common law of Ohio. In Tobacco & Allied Stocks v. Transamerica Corp., 143 F. Supp. 323 (D. Del. 1956), Rule X-10B-5 is referred to as "founded on common-law fraud." *Id.* at 327. See also Note, 42 Va. L. Rev. 537, 554 (1956). The author of this note concludes that the latter rule merely incorporates common-law disclosure requirements.