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CASE COMMENTS

DUTY TO DISCLOSE INSIDE INFORMATION ARISES FROM A FIDUCIARY OR SPECIAL RELATIONSHIP BETWEEN PARTIES TO A SECURITIES TRANSACTION

Chiarella v. United States, 445 U.S. 222 (1980)

In *Chiarella v. United States*¹ the Supreme Court limited the applicability of section 10(b) of the Securities Exchange Act of 1934² and SEC rule 10b-5³ by holding that an affirmative duty to disclose material nonpublic information arises from the existence of a special relationship⁴ between the buyer and seller of the securities.⁵

Defendant, an employee of a company engaged in printing corporate takeover bids, deduced from coded documents the identity of corporations targeted for takeover by the printing company's customers.⁶ Without disclosing this information, defendant purchased stock in the target companies and profitably sold the shares immediately after the

1. 445 U.S. 222 (1980).

2. 15 U.S.C. § 78j (1976) provides as follows:

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

.....
(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. 17 C.F.R. § 240.10b-5 (1980) provides as follows:

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

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

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

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

4. For further discussion of the term "special relationship," see notes 18, 33, 38-43, 50 *infra* and accompanying text.

5. 445 U.S. at 233, 235.

6. *Id.* at 224.

takeover attempts became public.⁷ Affirming the trial court⁸ verdict convicting Chiarella of violating section 10(b) and rule 10b-5,⁹ the Second Circuit Court of Appeals¹⁰ found that Chiarella breached an affirmative duty to disclose nonpublic information obtained by his regular access to market information.¹¹ The United States Supreme Court granted certiorari,¹² reversed,¹³ and *held*: Failure to disclose material¹⁴ nonpublic¹⁵ information in a securities transaction results in violation of section 10(b) and rule 10b-5 when a preexisting relationship between the parties gives rise to an affirmative duty to disclose the information.¹⁶

Traditionally, failure to disclose material information in a business

7. *Id.* "Of the five transactions, four involved tender offers and one concerned a merger." *Id.* at 224 n.1 (citing *United States v. Chiarella*, 588 F.2d 1358, 1363 n.2 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980)).

8. *United States v. Chiarella*, 450 F. Supp. 95 (S.D.N.Y.), *aff'd*, 588 F.2d 1358 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980). Prior to the trial court action, Chiarella entered a consent decree with the Securities and Exchange Commission in which he agreed to return his profits to the sellers of the shares of stock. *See SEC v. Chiarella*, No. 77 Civ. 2534 (GLG) (S.D.N.Y. May 24, 1977).

9. Most cases and commentators refer to both § 10(b) and rule 10b-5 when analyzing manipulative or deceptive actions in the securities market. *See, e.g.*, *List v. Fashion Park, Inc.*, 340 F.2d 457, 459 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 828-29 (D. Del. 1951), *aff'd*, 235 F.2d 369 (3d Cir. 1956); *Fleischer, Mundheim, & Murphy, An Initial Inquiry Into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 798 (1973); 10 SETON HALL L. REV. 720, 721-22 (1980).

10. *United States v. Chiarella*, 588 F.2d 1358 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).

11. *Id.* at 1365.

12. 441 U.S. 942 (1979).

13. 445 U.S. at 237.

14. Material information is that information to which "a reasonable man would attach importance . . . in determining his choice of action in the transaction in question." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (1968) (en banc), *cert. denied*, 394 U.S. 976 (1969) (quoting *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965)). *See Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 385 (1970); *Zweig v. Hearst Corp.*, 594 F.2d 1261, 1266 (9th Cir. 1979); *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1171 (2d Cir. 1970); *Kohler v. Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963); *In re Blyth & Co.*, 43 S.E.C. 1037, 1038 n.1(a) (1969); 1 F. HARPER & J. JAMES, TORTS 565-66 (1956). *See generally* *Fleischer, Mundheim & Murphy, supra* note 9, at 803; Note, *The Downstairs Insider: The Specialist and Rule 10b-5*, 42 N.Y.U. L. REV. 695, 706-07 (1967).

15. The term "[n]onpublic" refers to information that investors may not lawfully acquire without the consent of the source." *Brudney, Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 322 n.2 (1979). *See generally* ALI-ABA COURSE OF STUDY: FRAUD, INSIDE INFORMATION, AND FIDUCIARY DUTY UNDER RULE 10B-5 310-13 (Second Conference) (San Francisco) (1976).

16. 445 U.S. at 233, 235.

transaction was actionable only when the nondisclosing party owed a duty to the other party to disclose the information.¹⁷ The duty to disclose at common law thus arose from a fiduciary or special relationship of trust and confidence between the parties to the business transaction.¹⁸

To restore confidence in the financial marketplace after the stock market crash of 1929,¹⁹ Congress enacted the Securities Exchange Act of 1934.²⁰ In the early stages, the scope of liability under section 10(b) and rule 10b-5 of the Act was similar to that recognized at common

17. See, e.g., *Oliver v. Oliver*, 118 Ga. 362, 371, 45 S.E. 232, 235 (1903) (director, by virtue of his fiduciary position, must disclose facts before purchasing shareholder's stock in same corporation); *Hotchkiss v. Fisher*, 136 Kan. 530, 538, 16 P.2d 531, 535 (1932) (director of a corporation, being a fiduciary, has a duty to disclose material facts before purchasing shares from a shareholder in the same corporation); *Diamond v. Oreamuno*, 24 N.Y.2d 494, 497-99, 248 N.E.2d 910, 912, 301 N.Y.S.2d 78, 83 (1969) (corporate officer breaches a duty when he sells shares without disclosing information acquired by his position). Cf. *Strong v. Repide*, 213 U.S. 419, 434 (1909) (the special facts of the situation create the duty to disclose); *Brophy v. Cities Service Co.*, 31 Del. Ch. 241, 244, 70 A.2d 5, 7 (1949) (confidential secretary acquiring secret corporate information in the course of her employment occupies a position of trust and confidence analogous to that of a fiduciary). See generally 3 L. LOSS, *SECURITIES REGULATION* 1446-48 (2d ed. 1961); W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* 697 (4th ed. 1971); *RESTATEMENT (SECOND) OF TORTS* § 551(1) (1976); Note, *Purchaser's Duty to Disclose Under Securities and Exchange Commission Rule X-10b-5*, 40 MINN. L. REV. 62, 63 (1955); Note, *Rule 10b-5: Scope of Liability Extended as Former Outsiders Become Market Insiders*, 58 NEB. L. REV. 866, 872-74 (1979); Note, *Civil Liability Under Rule X-10b-5*, 42 VA. L. REV. 537, 546-47, 552-53 (1956).

18. See *Farmers State Bank of Newport v. Lamon*, 132 Wash. 369, 372-73, 231 P. 952, 953-54 (1925) (listing relationships when duty is imposed); note 17 *supra* and accompanying text. See generally W. PROSSER, *supra* note 17, at 696-97.

19. See *SEC v. Capital Gains Bureau*, 375 U.S. 180, 186 (1963) (securities industry abuses contributed to both the 1929 stock market crash and the great depression of the 1930's); *Silver v. New York Stock Exch.*, 373 U.S. 341, 366 (1963) (the Securities Exchange Act of 1934 was passed to control abuses in the stock exchanges). See generally 1 L. LOSS, *SECURITIES REGULATION* 120-21 (2d ed. 1961); Douglas and Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 171 (1933); Loomis, *The Securities Exchange Act of 1934 and the Investment Advisors Act of 1940*, 28 GEO. WASH. L. REV. 214, 216-17 (1959); 50 MISS. L.J. 223, 224, 224 n.11 (1979) (citing J. GALBRAITH, *THE GREAT CRASH* (1955)). Relevant statutes passed in response to the Great Depression include: The Securities Act of 1933, 15 U.S.C. §§ 77a-77aa; the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk; the Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-6; the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb; the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to 80a-52; and the Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1 to 80b-21.

20. 15 U.S.C. §§ 78a - 78kk (1977). See note 2 *supra* for relevant text.

law;²¹ corporate officers,²² directors²³ and controlling shareholders²⁴—the traditional insiders²⁵—had an affirmative duty to disclose material

21. *Compare* *Oliver v. Oliver*, 118 Ga. 362, 45 S.E. 232 (1903) (common law-action against a director); *Hotchkiss v. Fisher*, 136 Kan. 530, 16 P.2d 531 (1932) (common law-action against a director) and *Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969) (common-law action against an officer) with *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951) (rule 10b-5 action against parent corporation); *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947) (rule 10b-5 action against officers and directors) and *In re Ward La France Truck Corp.*, 13 S.E.C. 373 (1943) (rule 10b-5 action involving officers who were also majority shareholders). See generally Note, *Rule 10b-5: Scope of Liability Extended as Former Outsiders Become Market Insiders*, 58 NEB. L. REV. 866, 877 (1979); Comment, *A New Concept of Fraud on the Securities Exchange—A Comment on In re Cady, Roberts & Co.*, 15 S.C. L. REV. 557, 565-66 (1963).

Section 16(b) of the Securities Exchange Act of 1934 directly addresses insider trading. 15 U.S.C. § 78p(b) (1976). Section 16(a), however, is concerned explicitly with officers, directors, and shareholders owning over ten percent of any class of beneficial securities in a registered issuer. *Id.* § 78p(a). Rule 10b-5 was promulgated in 1942 to provide additional protection for investors. See Exchange Act Release No. 3230 (May 21, 1942). See generally 5 A. JACOBS, THE IMPACT OF RULE 10b-5 § 2, at 1-5, § 3.02(h), at 1-106 (rev. 1980).

22. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 852 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969) (officers held liable for buying shares of their corporation's stock without disclosing their knowledge of a potential ore discovery); *Kardon v. National Gypsum Co.*, 73 F. Supp. 798, 800 (E.D. Pa. 1947) (officers of corporation liable under rule 10b-5 despite lack of oral misrepresentations or half-truths); *In re Ward La France Truck Co.*, 13 S.E.C. 373, 376-79 (1943) (officers found liable for failure to disclose material inside information before a broker-dealer bought publicly held shares of the corporation).

23. See *Pennaluna & Co. v. SEC*, 410 F.2d 861, 869-70 (9th Cir. 1969), *cert. denied*, 396 U.S. 1007 (1970) (broker-dealer, acting as director, liable for trading on inside information); *Kohler v. Kohler Co.*, 319 F.2d 634, 638, 642 (7th Cir. 1963) (directors cannot trade on nonpublic information gained by reason of their position); *Childs v. RIC Group, Inc.*, 331 F. Supp. 1078, 1082-84 (N.D. Ga. 1970), *aff'd per curiam*, 447 F.2d 1407 (5th Cir. 1971) (director liable for purchasing shareholder's stock without disclosing negotiations concerning resale to a third party); *Kardon v. National Gypsum Co.*, 73 F. Supp. 798, 800 (E.D. Pa. 1947) (director of corporation liable under rule 10b-5 despite lack of oral misrepresentations or half-truths).

24. See *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 828-29 (D. Del. 1951) (parent corporation liable under rule 10b-5 for purchasing stock from minority shareholders without informing them of subsidiary's true inventory value). Cf. *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977) (favorable dictum for finding liability, but Court found no violation on the facts); *James Blackstone Memorial Library Ass'n v. Gulf, M. & O.R.R.*, 264 F.2d 445 (7th Cir.), *cert. denied*, 361 U.S. 815 (1959) (favorable dictum for finding liability, but court found no violation on the facts).

25. "An insider is a person who: (1) possesses inside information, (2) knows or should know the information is nonpublic, and (3) receives the information in his business capacity and for a legitimate business reason by virtue of a relationship giving access, directly or indirectly, to the information." 5 A. JACOBS, *supra* note 21, § 66.02[a], at 3-327. The American Law Institute defines insider as "a person who, by virtue of his relationship or former relationship to the issuer, knows a fact of special significance about the issuer or the security in question that is not generally available" ALI FED. SEC. CODE § 1603(b)(3), at 655 (Official Draft 1980). Inside information is information emanating from the issuer or its insiders. FIFTH ANNUAL INSTITUTE ON SE-

inside information before trading on the basis of that information.²⁶

The first significant expansion of the rule 10b-5 obligation to disclose occurred in *In re Cady, Roberts & Co.*²⁷ In *Cady, Roberts* a broker-dealer, acting on a tip from an associate in his firm, sold his clients' shares in a corporation.²⁸ Because the associate obtained the nonpublic information through his inside position on the corporation's board of directors, the Commission held that the broker-dealer violated rule 10b-5 by failing to disclose inside information before trading on the basis of the information.²⁹ The Commission reasoned that the associate's insider status and duty to disclose extended to the broker-dealer³⁰ as tippee.³¹ Although the Commission used broad language in determining the extent of the tippee's obligation to disclose,³² its decision recognized a special relationship between the issuing company and the

CURITIES REGULATION 288-89 (Mundheim, Fleischer and Schupper, eds. 1974) (PLI Conference) (remarks by Mr. Marty Lipton).

The courts' early definition of insider, also referred to as the traditional insider definition, was based on the statutory restriction on corporate officers, directors, and primary stockholders, from short-swing trading. 50 Miss. L.J. 223, 226 n.24 (1979) (construing 15 U.S.C. § 78p(a) (1976)). For further discussion of 15 U.S.C. § 78p(a), see note 21 *supra*.

26. If a person possessing nonpublic information is unable to disclose the information in order to protect a corporate confidence, he must abstain from trading. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). *Accord*, *Fridrich v. Bradford*, 542 F.2d 307, 314 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 236-37 (2d Cir. 1974); *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876, 887 (2d Cir. 1972).

27. 40 S.E.C. 907 (1961). See generally Comment, *Insider Liability Under Securities Exchange Act Rule 10b-5: The Cady, Roberts Doctrine*, 30 U. CHI. L. REV. 121 (1962).

28. 40 S.E.C. at 912.

29. *Id.* at 912-13.

30. *Id.* at 912-15.

31. A tippee is a person who receives material nonpublic information from an insider. The extension of rule 10b-5 liability to tippees is an extension of the officer's fiduciary duty. Tippee liability is premised on the theory that the tippee is participating in the traditional insider's breach of fiduciary duty. See 3 L. Loss, *supra* note 17, at 1450-53; Fleischer, *supra* note 9, at 818 n.76. See, e.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237-38 (2d Cir. 1974); *Ross v. Licht*, 263 F. Supp. 395, 410 (S.D.N.Y. 1967); *In re Investors Management Co.*, 44 S.E.C. 633, 641 (1971).

The distinction between an insider and a tippee stems from the circumstances under which each receives the inside information. A tippee, in contrast to an insider, either does not learn the inside information in a business capacity, or does not have a legitimate business reason for knowing the inside information. Despite their different means of obtaining the inside information, they both have the same duty of disclosure. 5 A. JACOBS, *supra* note 21, § 66.02[a], at 3-315 to -329.

32. The Commission stated:

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

insider.³³ The duty to disclose arose from this special relationship between the company and the insider.³⁴

The Second Circuit Court of Appeals further expanded rule 10b-5 liability in *SEC v. Texas Gulf Sulphur Co.*,³⁵ holding officers and employees of Texas Gulf Sulphur liable for purchasing shares of the corporation's stock without disclosing their knowledge of a potential ore discovery.³⁶ The extension of liability in *Texas Gulf Sulphur* to employees, traditionally considered not to be insiders,³⁷ led courts to hold broker-dealers,³⁸ accountants,³⁹ attorneys,⁴⁰ banks,⁴¹ stock exchanges,⁴²

second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

40 S.E.C. at 912 (footnotes omitted). For examples of how this test has been applied, see *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); *In re Investors Management Co.*, 44 S.E.C. 633, 640 (1971).

33. "Thus our task here is to identify those persons who are in a *special relationship with a company* and privy to its internal affairs, and *thereby suffer correlative duties* in trading in its securities." 40 S.E.C. at 912 (emphasis added).

34. *Id.*

35. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

36. *Id.* at 852. Officers and employees who obtained knowledge of a potential ore discovery by visual evaluation of the site and by drill core results had a duty to disclose this material information to Texas Gulf Sulphur shareholders before purchasing their stock. *Id.*

37. Nontraditional insiders include "[a] broad range of . . . persons [who] may, under appropriate circumstances, be deemed insiders." ALI-ABA COURSE OF STUDY, *supra* note 15, at 104. For a list of persons who may be treated as insiders, see 5 A. JACOBS, *supra* note 21, § 66.02[a], at 3-283 to 3-287; ALI-ABA COURSE OF STUDY, *supra* note 15, at 104-05; TEXAS GULF SULPHUR-INSIDER DISCLOSURE PROBLEMS 206 (Fleischer & Flom co-chairmen) (PLI forum) (McCord & Cohen eds.) (remarks by Mr. Alan Bromberg).

38. *See Shapiro v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*, 495 F.2d 228, 236-37 (2d Cir. 1974) (broker-dealer, while engaged as a managing underwriter for a corporation planning a debenture offering, tipped customers to sell that corporation's stock); *Wohl v. Blair*, 50 F.R.D. 89, 91 (S.D.N.Y. 1970) (broker-dealers used fraud to induce plaintiffs to purchase stock in a corporation) (case decided on a procedural issue); *In re Blyth & Co.*, 43 S.E.C. 1037, 1040 (1969) (broker-dealer traded on nonpublic information obtained from a Federal Reserve Bank employee). *See generally* Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers*, 57 CORNELL L. REV. 869 (1972).

Brokers are also subject to specific regulations in the Securities Exchange Act of 1934. *See* 15 U.S.C. §§ 78h, 78k, 78o-1 to -3 (1976).

39. *See Herzfeld v. Laventhol, Krekstein, Horwath and Horwath*, 378 F. Supp. 112, 121-22 (S.D.N.Y. 1974) (accountants, treated as insiders of their client's corporation, incurred a duty to disclose information about their client before shares of the client's corporation are traded based on a materially misleading financial statement), *aff'd in part and rev'd in part on other grounds*, 540 F.2d 27 (2d Cir. 1976). *See generally* Glickman, *'Tippee' Liability Under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934*, 20 KAN. L. REV. 47, 52 (1971); Poole, *Corporate 'Insiders' Face More Regulation*, 48 MICH. ST. B.J. 28, 39 (1963).

40. *See United States v. Peltz*, 433 F.2d 48 (2d Cir. 1970), *cert. denied*, 401 U.S. 955 (1971)

and corporations⁴³ liable under similar extensions of the breadth of "insider" and the consequential duty to disclose. In the successful rule 10b-5 claims based on failure to disclose nonpublic information, a nexus exists between the insider—traditional or nontraditional—and the corporation whose securities were traded.⁴⁴

Broad language in *Texas Gulf Sulphur* prompted further suggestions for judicial expansion of rule 10b-5 liability to parties trading on the basis of undisclosed information.⁴⁵ Several decisions after *Texas Gulf*

(attorney trading on inside information obtained from SEC employee). See generally Glickman, *supra* note 39, at 52; Poole, *supra* note 39, at 39.

41. See *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 154 (1972) (liability of bank having knowledge that its employees are acting to defraud its customers held to be co-extensive with employees). See generally Poole, *supra* note 39, at 39. For further discussion of *Affiliated Ute Citizens*, see text accompanying notes 53-58 *infra*.

42. See *Carr v. New York Stock Exch., Inc.*, 414 F. Supp. 1292, 1300 (N.D. Cal. 1976) (dictum) (a stock exchange could be liable if it fails to inform investors in a member firm of material information concerning that firm's financial and operating condition).

43. See *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 796 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970) (an acquiring corporation is an insider of a target company when secret communications are made between the acquiring corporation and the management of the target company); *Brennan v. Midwestern United Life Ins. Co.*, 417 F.2d 147, 154-55 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970) (corporation liable under rule 10b-5 for failing to disclose to purchasers that securities dealer was making false statements about the corporation); *SEC v. Great Am. Indus., Inc.*, 407 F.2d 453, 458-59 (2d Cir. 1968), *cert. denied*, 395 U.S. 920 (1969) (corporation and its officers enjoined for rule 10b-5 violations).

44. *Lewelling v. First Calif. Co.*, 564 F.2d 1277 (9th Cir. 1977) (brokerage firm owes duty to purchaser of stock); *Shapiro v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*, 495 F.2d 228, 239 (2d Cir. 1974) (broker-dealer owes a duty to the corporation for which it is involved as underwriter); *Pennaluna & Co. v. SEC*, 410 F.2d 861, 869-70 (9th Cir. 1969), *cert. denied*, 396 U.S. 1007 (1970) (broker-dealer has same duties as a traditional insider). Cf. *Zweig v. Hearst, Corp.*, 594 F.2d 1261, 1271 (9th Cir. 1979) (financial columnist owes duty to the general public); *Herzfeld v. Laventhol, Krekstein, Horwath and Horwath*, 378 F. Supp. 112, 121-22 (S.D.N.Y. 1974) (accountants owe a duty to the investors because the investors rely on their statements). See generally Note, *Rule 10b-5: Scope of Liability Extended as Former Outsiders Become Market Insiders*, 58 NEB. L. REV. 866, 879 (1979).

45. An example of the broad language in *Texas Gulf Sulphur* is the following:

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

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

For cases following this broad formulation, see, e.g., *Strong v. France*, 474 F.2d 747, 752 (9th Cir. 1973); *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876, 887 (2d Cir. 1972); *Jefferies & Co. v. Arkus-Duntov*, 357 F. Supp. 1206, 1214 (S.D.N.Y. 1973). Cf. *SEC v. Great Am. Indus., Inc.*, 407 F.2d 453, 462-63 (2d Cir. 1968) (Kaufman, J., concurring), *cert. denied*, 395 U.S. 920 (1969) (a willingness expressed to find liability under rule 10b-5 regardless of whether the defendant had a fiduciary or special relationship with the corporation whose shares were traded).

For arguments that rule 10b-5 can and should be expanded, see Comment, *The Application of*

Sulphur, however, significantly limited the broad implications of that decision.⁴⁶ In *General Time Corp. v. Talley Industries*⁴⁷ the court refused to find liability under rule 10b-5 absent a prior fiduciary relationship between a tender offeror and issuer.⁴⁸ The Second Circuit in *SEC v. Great American Industries*⁴⁹ stated that to place the duty of disclosure on a party not occupying a special relationship to a seller or buyer of securities would be a novel interpretation of rule 10b-5.⁵⁰

The Supreme Court expanded the special relationship concept in *Affiliated Ute Citizens v. United States*.⁵¹ Defendant bankers functioned both as transfer agents⁵² for a group of Indians and as market makers⁵³

Rule 10b-5 to "Market Insiders", 92 HARV. L. REV. 1538, 1543-44 (1979); 1980 WIS. L. REV. 162, 184-88. See also Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 353-67 (1979); Keeton, *Fraud—Concealment and Non-disclosure*, 15 TEX. L. REV. 1, 25-26 (1936).

For an analysis contending that expansion of rule 10b-5 is supported by the legislative history of the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1976), and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1976), see 1980 WIS. L. REV. 162, 178-81. For arguments reaching the opposite conclusion, see Memorandum Amicus Curiae of the Securities Industry Association at 22-23, *Chiarella v. United States*, 445 U.S. 222 (1980); Brief for the Petitioner at 16 n.5, *Chiarella v. United States*, 445 U.S. 222 (1980). *Accord*, 5 A. JACOBS, *supra* note 21, at § 6.03.

46. See notes 47-50 *infra* and accompanying text.

47. 403 F.2d 159 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969).

48. *Id.* at 161-64. In *General Time* the issuer's shareholders who sold before disclosure of the merger plans did so at a lower price than if the merger plans had been made public. Nevertheless, the court stated that they knew of no rule of law requiring a purchaser of stock, who is not an insider and has no fiduciary relationship to a prospective seller, to reveal circumstances that might raise a seller's demands and thus abort the sale. *Id.* at 164.

Later, in *Frigitemp v. Financial Dynamics Fund*, 524 F.2d 275 (2d Cir. 1975), a purchaser corporation did not disclose to an issuer that while it was purchasing the issuer's debenture, it was also purchasing the issuer's over-the-counter stock. The court held that the corporation had no duty to disclose its intent to purchase the issuer's over-the-counter stock by virtue of its being a purchaser. *Id.* at 278-79.

49. 407 F.2d 453 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 920 (1969).

50. *Id.* at 460.

51. 406 U.S. 128 (1972).

52. "A transfer agent keeps a record of the name of each registered shareowner, his or her address, the number of shares owned, and sees that certificates presented to his office for transfer are properly cancelled and new certificates issued in the name of the transferee." BLACK'S LAW DICTIONARY 1342 (5th ed. 1979). In *Affiliated Ute Citizens* the defendant bank held all the certificates and issued receipts to the shareholders. 406 U.S. at 136-37.

53. The SEC defines a market maker as:

[A] dealer who, with respect to a particular security, holds himself out (by entering indications of interest in purchasing and selling in an inter-dealer quotations system or otherwise) as being willing to buy and sell for his own account on a continuous basis otherwise than on a national securities exchange.

SEC Rule 17A-9(f)(1), 17 C.F.R. § 240.17a-(9)(f) (1980). A market maker is usually a broker-dealer. See, e.g., *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1170 (2d Cir. 1970); *In re Blythe*

for the Indians' tribal assets, which were being distributed as stock certificates.⁵⁴ The bankers purchased stock from the Indians without disclosing that the stock could be sold at a higher price in another market.⁵⁵ The Court found a duty to disclose arising from the special relationship between the bankers, as transfer agents and market makers, and the Indians.⁵⁶

Following *Affiliated Ute Citizens*, the United States Supreme Court limited the scope of rule 10b-5, holding that the rule does not provide a cause of action when a complaint does not allege deception or manipulation,⁵⁷ when a claim is for negligence,⁵⁸ or when the complainant is not a buyer or seller of securities.⁵⁹

In *Chiarella v. United States*⁶⁰ the United States Supreme Court asserted that failure to disclose nonpublic market information before buying or selling securities is not fraud under section 10(b) unless the person using the information has a duty to disclose the information before trading.⁶¹ The significance of the opinion, however, lies in the majority's declaration that a duty to disclose arises when "one party to a transaction has information that the other party is entitled to know because of a fiduciary or similar relation of trust and confidence between them."⁶²

Justice Powell, writing for the majority, analyzed the language of section 10(b) and its legislative history,⁶³ and concluded that neither source provides guidance for determining when nondisclosure of nonpublic information constitutes a violation of section 10(b) or rule 10b-5.⁶⁴ Turning to case law, Justice Powell analyzed *Cady, Roberts*,⁶⁵

& Co., 43 S.E.C. 1037 (1969). A financial columnist who bought stocks before recommending them has also been held a market maker. *Zweig v. Hearst Corp.*, 594 F.2d 1261 (9th Cir. 1979).

54. 406 U.S. at 152.

55. *Id.* at 153.

56. *Id.* at 152-53. One interpretation of this case is that the special relationship requiring a duty to disclose arose from the Indians' trust and confidence in the bankers. *Fleischer, Mundheim, & Murphy*, *supra* note 9, at 820.

57. *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473-74 (1977).

58. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200 (1976).

59. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 735-36 (1975).

60. 445 U.S. 222 (1980).

61. *Id.* at 231.

62. *Id.* at 228 (quoting RESTATEMENT (SECOND) OF TORTS § 551(a)(a) (1976)).

63. 445 U.S. at 225-26.

64. 445 U.S. at 226. *But see* note 45 *supra*.

65. *Id.* at 226-28. *See* notes 27-34 *supra* and accompanying text.

Texas Gulf Sulphur,⁶⁶ and *Affiliated Ute Citizens*⁶⁷ and found that an affirmative duty to disclose under section 10(b) arises only when a special relationship between the transacting parties exists.⁶⁸ Absent a special relationship between the party possessing the nonpublic information and the issuer, there is no duty to disclose.⁶⁹

Justice Powell rejected the regular access to market test,⁷⁰ which imposed 10b-5 liability on anyone trading before disclosing nonpublic information obtained because of regular access to the information.⁷¹ He reasoned that liability based on regular access to market information is incorrect because financial unfairness is not necessarily fraud under section 10(b) and because the element required to make silence fraud—

66. 445 U.S. at 229. See notes 35-36, 45 *supra* and accompanying text.

67. 445 U.S. at 229-30. See notes 51-56 *supra* and accompanying text.

68. 445 U.S. at 227-28, 230.

69. *Id.* at 229 (citing *General Time Corp. v. Talley Indus.*, 403 F.2d 159, 164 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969)). For further discussion of *General Time*, see notes 47-48 *supra* and accompanying text.

70. 445 U.S. at 232-33. The regular access to market information test declares that "anyone—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose." *United States v. Chiarella*, 588 F.2d 1358, 1365 (2d Cir. 1978) (emphasis in original), *rev'd*, 445 U.S. 222 (1980).

71. 445 U.S. at 232-33. Justice Powell was concerned with whether rule 10b-5 can be interpreted to impose a policy of parity of information. He concluded that a policy of parity cannot be derived from rule 10b-5, and thus did not reach the issue of whether parity should be imposed.

For arguments that parity should be imposed, see FIFTH ANNUAL INSTITUTE ON SECURITIES REGULATION 294-304 (Mundheim, Fleischer and Schupper, eds. 1974) (PLI conference); Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425 (1967). See also *White Paper on Company Law Reform*, Cmnd. No. 5391 at 8 (July, 1973) (printed in VII REPORTS, ACCOUNTS AND PAPERS (1972-1973)) (England) (quoted in Mundheim, *supra*, at 295). For arguments reaching the opposite conclusion, see H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 138-41 (1966); Fleischer, Mundheim & Murphy, *supra* note 9, at 816; Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547 (1970); ABA Comment Letter on Material, Non-Public Information (printed in SEC. REG. & L. REP. (BNA) D-1, D-2, D-6, no. 233, January 2, 1974); P. Loomis, *Some Reflections on Rule 10b-5 and Market Information* 12-13 (Remarks before Second Annual ALI-ABA Course of Study, San Francisco, May 6, 1976) (on file with the WASHINGTON UNIVERSITY LAW QUARTERLY) (cited in Brudney, *supra* note 15, at 340 n.63).

California has resolved the "should" question of parity in the securities market by enacting a state statute requiring equal access to information. See CAL. CORP. CODE § 25402 (Deering 1979).

Adoption of an equal access test also raises due process questions. See Deutch, *The New Deal and the Burger Court: The Significance of United States v. Chiarella*, 57 TEX. L. REV. 965 (1979); Comment, *Due Process: Notice Requirements Under Rule 10b-5*, 79 ARIZ. ST. L.J. 651 (1979); Comment, *Rule 10b-5: Birth of the Concept of Market Insider and Its Application in a Criminal Case*, 8 FORDHAM URB. L.J. 467, 477 (1980); Nat'l L.J., May 26, 1980, at 27, col. 1.

a duty to disclose—was not present in this transaction.⁷²

Responding to the Government's argument that Chiarella breached a duty to the acquiring corporation, Justice Powell found that the issue was not submitted to the jury and, therefore, was not properly before the Court.⁷³ Justice Stevens, concurring, emphasized that the Court was not ruling on whether Chiarella owed a duty to the acquiring corporation.⁷⁴

Justice Brennan, concurring separately, and Chief Justice Burger, dissenting, rejected the theory that a duty to disclose under section 10(b) arises from the mere possession of nonpublic information.⁷⁵ The Chief Justice elucidated a misappropriation theory that imposes liability on persons who trade securities based on illegally obtained information.⁷⁶

Justice Blackmun, in a dissenting opinion joined by Justice Marshall, advocated extension of liability under section 10(b) and rule 10b-5 to persons exploiting a structural informational advantage by trading in affected securities.⁷⁷ Relying on broad language in the legislative history and earlier cases interpreting rule 10b-5,⁷⁸ Justice Blackmun concluded that rule 10b-5 mandates liability for persons trading securities

72. 445 U.S. at 232-33.

73. *Id.* at 236.

74. *Id.* at 238 (Stevens, J., concurring).

75. *Id.* at 238-39 (Brennan, J., concurring), *id.* at 240 (Burger, C.J., dissenting). Although Justice Brennan and Chief Justice Burger interpreted the jury instructions differently, *id.* at 239 (Brennan, J., concurring), *id.* at 243-45 (Burger, C.J., dissenting), Justice Brennan accepted the Chief Justice's misappropriation theory. *Id.* at 239 (Brennan, J., concurring). For discussion of the misappropriation theory, see note 76 *infra* and accompanying text.

76. *Id.* at 239-43 (Burger, C.J., dissenting). Because only the Chief Justice considered the misappropriation theory to have been given to the jury, see note 75 *supra*, that theory did not become a major concern in the case. The Court, Chief Justice Burger explained, did not reject the misappropriation theory; it simply did not address it because it had not been given to the jury. Chief Justice Burger does not believe that the misappropriation theory is necessarily incompatible with the majority's holding. 445 U.S. at 243 n.4 (Burger, C.J., dissenting).

Justice Powell, however, noted the related problems that would arise if the misappropriation theory had become a significant issue in this case. *Id.* at 237 n.21.

77. *Id.* at 251-52 (Blackmun, J., dissenting).

78. Justice Blackmun noted that Congress recognized a purpose "to assure that dealing in securities is fair and without undue preferences or advantages among investors." *Id.* at 248 (Blackmun, J., dissenting) (quoting H.R. CONF. REP. No. 94-229, 94th Cong., 1st Sess. 91, *reprinted in* [1975] U.S. CODE CONG. & AD. NEWS 323).

Justice Blackmun also stated that "by repeated use of the word 'any,' " the statute and rule "are obviously meant to be inclusive." 445 U.S. at 250 (Blackmun, J., dissenting) (quoting *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972)).

without disclosing confidential information not available to others.⁷⁹

The majority's refusal to extend rule 10b-5 liability absent a relationship of trust and confidence is commendable. Liability for nondisclosure under rule 10b-5 is premised on the existence of such a relationship between the transacting parties.⁸⁰ Silence is fraud under the rule only when an affirmative duty to disclose exists.⁸¹ Because the duty to disclose arises within the context of a fiduciary relationship between the transacting parties,⁸² *Chiarella* does not reduce the efficacy of rule 10b-5's demands on traditional and nontraditional insiders who trade with persons to whom they owe a duty.

By refusing to construe rule 10b-5 broadly, the Court refused to adopt a policy of equal access to information.⁸³ Finding liability for nondisclosure without requiring a special relationship between the insider and the corporation whose shares are traded would be a radical departure from established law.⁸⁴ Discarding the nexus requirement is tantamount to declaring a policy of equal access to information.⁸⁵ Because the legislative history provides no explicit support for such a change in policy,⁸⁶ the Court properly refused to adopt the equal access to information standard.

Justice Blackmun's dissent is unpersuasive. Broad language from the legislative history and earlier case law⁸⁷ provide a weak basis for concluding that Congress desired rule 10b-5 to require equal access to information. He ignores the Williams Act⁸⁸ and warehousing⁸⁹—two

79. 445 U.S. at 251-52 (Blackmun, J., dissenting).

80. See notes 38-44, 48, 50 *supra* and accompanying text.

81. See note 61 *supra*.

82. See notes 38-44, 48-50, 51-62, 68 *supra* and accompanying text.

83. See notes 70-71 *supra* and accompanying text.

84. See note 17 *supra* and accompanying text.

85. See note 70 *supra* and accompanying text.

86. See note 45 *supra*. Although the legislative history provides no explicit support for such a change in policy, it is arguable that the legislative history reveals that a policy of parity is not within the lawmakers' expectations. This contention gets its strongest support from the Williams Act and "warehousing." See 445 U.S. at 233.

The Williams Act, 15 U.S.C. § 78m(d)(1) (1976), permits a tender offeror to purchase up to five percent of the target company's stock prior to disclosure of its plans for acquisition.

"Warehousing" takes place when a corporation gives advance notice to institutional investors of its intention to launch a tender offer. These investors are then able to purchase stock in the target company before the tender offer is made public and the price of the shares rises. See 445 U.S. at 234 (citing *Fleischer, Mundheim & Murphy*, *supra* note 9, at 811-12).

87. See note 78 *supra* and accompanying text.

88. 15 U.S.C. § 78m(d)(1) (1976). See note 86 *supra*.

89. See note 86 *supra*.

examples in which Congress and the Commission expressly allowed persons to trade securities with unequal access to information. Interpreting legislative intent by focusing on vague language in the legislative history and ignoring express evidence results in a substitution of the Court's view for that of the legislature. The Court is not at liberty to make such a substitution.⁹⁰

Chiarella provides clear guidelines for the lower courts. Criminal liability under rule 10b-5 results when a person failing to disclose information owes a duty to disclose that information to the other party in the transaction.⁹¹ Courts will impose a duty of disclosure when "a fiduciary or similar relation of trust and confidence exists between [the transacting parties]."⁹²

Several rule 10b-5 issues are left open to speculation after *Chiarella*. The role of the misappropriation theory in future situations similar to *Chiarella* is unclear.⁹³ Further, rule 14e-3,⁹⁴ promulgated after the Court's decision in *Chiarella* to fill the nondisclosure gap created by that decision, demands disclosure in future *Chiarella*-type situations.

The Court in *Chiarella* clarified actionable nondisclosure under section 10(b) and rule 10b-5. Liability for nondisclosure is based on a duty to disclose that arises from a fiduciary or special relation between the transacting parties. Liability for nondisclosure thus cannot be based solely on a claim that a person bought or sold securities while possessing unequal access to information.⁹⁵

90. In a recent case interpreting rule 10b-5 the Supreme Court stated that federal courts are "not at liberty to legislate" a different result from the one Congress has ordained. *Touche Ross & Co. v. Redington*, 442 U.S. 560, 579 (1979). *Cf. Griswold v. Connecticut*, 381 U.S. 479, 482 (1965) (the Court does not sit as a superlegislature). *See generally* J. NOWAK, R. ROTUNDA & J. YOUNG, HANDBOOK ON CONSTITUTIONAL LAW 404-10 (1978).

91. *See* note 11 *supra* and accompanying text.

92. *See* note 62 *supra* and accompanying text.

93. *See* note 76 *supra* and accompanying text.

94. 45 Fed. Reg. 60,410, 60,411 (Sept. 12, 1980) (to be codified in 17 C.F.R. § 240.14e-3).

95. *See* notes 70-71, 83-86 *supra* and accompanying text. It is interesting to note that the American Law Institute's proposed federal securities code, recently endorsed by the SEC, see *Legal Times of Washington*, Sept. 22, 1980, at 1, 8, col. 1, does not include a requirement of equal access to information. *See* ALI FED. SEC. CODE § 1603(a) (Proposed Official Draft 1978).