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A DEVELOPMENT IN INSIDER TRADING LAW IN THE UNITED STATES: A CASE NOTE ON *CHIARELLA v. UNITED STATES*

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In *Chiarella v. United States* [1], the United States Supreme Court reversed the criminal conviction under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the Securities and Exchange Commission (SEC) of a financial printer employee who had deduced the names of target companies from documents he was working on for the bidder, purchased stocks in the target companies before the bids were announced, and sold at higher prices immediately after the bids were made public. The narrow holding of the Court was that the trial court's instruction to the jury, that Chiarella could be convicted merely on the basis that he knew of the forthcoming bid and willfully failed to inform the sellers, was improper. The Court stated: "We hold that a duty to disclose under § 10(b) does not arise from the mere possession of non-public market information". While Chiarella's conviction was reversed, he did not avoid the consequences of his acts. The SEC had previously sued him in a civil injunctive proceeding to which he consented and in which he agreed to return his $ 30,000 profit to the sellers. He also lost his job.

Before describing the interesting discussion in the majority, concurring and dissenting opinions, it is important to emphasize that the holding in the case is very narrow and that it is unclear what the Supreme Court would hold in cases where a different theory of culpability is presented. Section 10(b) of the 1934 Act [2] prohibits the use "in connection with the purchase or sale of any security . . . [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe". Pursuant to this section, the SEC in 1942 Promulgated Rule 10b-5 [3] which provides:

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

(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

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(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.

At the outset, the Supreme Court notes that subparagraph (2) of Rule 10b-5 is not at issue in this case because Chiarella had made no statements at all [4]. Accordingly, the issue in the case is the legal effect of silence when one is in possession of material non-public information. First, the Court finds that neither the language of the statute, the legislative history nor the SEC's statement when promulgating Rule 10b-5, affords specific guidance for the resolution of the case. Second, the prior administrative and judicial interpretations are reviewed and are found to

establish that silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10b ... but such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction.

Several important proceedings and cases are discussed by the Supreme Court and are useful in that they provide a general legal background both for the Court's decision and for the discussion in this article:

Cady, Roberts [5] in which the SEC held that a broker-dealer and his firm violated Section 10(b) by selling securities on the basis of undisclosed information (determination to reduce dividends) obtained from a director of the issuer corporation who was also an employee of the brokerage firm; the SEC said that a corporate insider must disclose or abstain from trading.

Texas Gulf Sulphur [6] in which the Court of Appeals for the Second Circuit held that corporate insiders (directors and officers) violated Section 10(b) by trading on undisclosed information (large ore discovery) for their own benefit. The Court also cites the case involving tippees of corporate insiders arising out of the same fact situation, noting that the "tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty".

Affiliated Ute [7] where the Supreme Court held that a bank making a market in shares of a corporation holding Indian assets was more than a mere transfer agent and had a duty to advise Indians trading in the securities of a second trading market maintained by the bank for trading by non-Indians in which the shares traded at higher prices.

General Time Corp. v. Talley Industries, Inc. [8] in which a purchaser of stock who has no duty to a prospective seller because he is neither an insider nor a fiduciary has no obligation to reveal material facts.

The Supreme Court is clear with respect to the two ends of the trading on material non-public information spectrum: at one end, there is no liability for merely trading on such information; at the other end, where the possessor of such information has a duty to the other party to the transaction (*e.g.* an insider), he is liable if he trades. What the Court discusses but does not clearly reject or endorse is liability where there is more than mere possession of material non-public information (*e.g.* where the information has been misappropriated) but there is no "relationship of trust and confidence between the parties to a transaction". The majority opinion uses the words quoted at the end of the previous sentence and suggests that only "a relationship between [Chiarella] and the sellers ... could give rise to a duty to disclose". Both sentences suggest that the majority sees some duty or relationship of trust to the sellers directly as a requisite element in Section 10(b) cases of non-disclosure.

In contrast, Mr. Chief Justice Burger (in dissent) and Mr. Justice Brennan (in concurrence) argue that "an absolute duty to disclose or refrain arises from ... misappropriation of information". Mr. Justice Stevens (in concurrence) points out that respectable arguments could be made on both sides of the misappropriation theory. Mr. Justice Blackmun and Mr. Justice Marshall (in dissent) indicate that they agree with the Chief Justice's theory although they would go further and hold that use of the information even if the information is not stolen, would violate Section 10(b).

The various members of the Court appear to be struggling to devise a formula for non-disclosure cases which would not mandate a "parity of information" rule since to do so would prevent buyers or sellers of securities from capitalizing on analytical skills, hard work, foresight, and even luck. A further concern is the fact that Section 10(b) has been recognized as not preventing specialists, block positioners and ordinary market makers from exploiting their informational advantage. Moreover, the Williams Act appears to specifically sanction the acquisition by a takeover bidder of less than 5% of the shares of the target corporation's stock before the public announcement of the offer [9].

On the other hand there would appear to be every reason to apply Section 10(b) to cases such as a judge's clerk trading on information in an opinion before it is published, a government employee who trades on a secret report or a newspaper columnist who buys a security just before favorably commenting on it in his column [10].

The SEC, in the Brief for the Government, suggested an alternative theory for the conviction of Chiarella which could also be applied to the types of situations listed above. They argued that Chiarella

> breached a duty to the acquiring corporation when he acted upon information that he obtained by virtue of his position as an employee of a printer employed by the [bidder]. The breach of this duty ... support[s] a conviction under § 10(b) for fraud perpetrated upon both the acquiring corporation and the seller.

The majority opinion does not decide whether the government theory has merit since it holds that the theory was in any event not presented to the jury.

In sum, the majority opinion (Mr. Justice Powell for himself and Justices Rehnquist, White, and Stewart) does not indicate whether it would find liability where there is a misappropriation of information if there is no special relationship between the buyer and the seller (indeed some of its language suggests it would require such a special relationship). However, at least four of the nine Justices, *i.e.* Burger, Brennan, Blackmun, and Marshall indicate that they would not require such a special relationship but would rest liability on a misappropriation theory. Stevens maintains, as stated earlier, that respectable arguments could be made on both sides.

Notes

[1] Chiarella v. United States, 445 U.S. 222 (1980).
[2] *15 U.S.C. § 78(j) (1976).*
[3] 17 C.F.R. § 240. 10b-5 (1980). Milton Freeman, a former SEC Staff member recounts the birth of Rule 10b-5 as follows:

It was one day in the year 1943, I believe, I was sitting in my office in the SEC building in Philadelphia and I received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, "I have just been on the telephone with Paul Rowen," who was then the SEC Regional Administrator in Boston, "and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at $ 4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be $2.00 a share for this coming year. Is there anything we can do about it?" So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where "in connection with the purchase or sale" should be, and we decided it should be at the end. 22 Bus. Law. 922 (1967).

[4] In the civil context the Supreme Court has questioned whether this language, which has a negligence rather than a fraud flavor, goes beyond the statute. *See* Ernst and Ernst v. Hochfelder, 425 U.S. 185 (1976), holding that liability in a private damage action under § 10(b) and Rule 10b-5 requires a finding of intent to defraud (scienter). In that case the court left open the question whether recklessness might constitute fraud for this purpose.
[5] In the matter of Cady, Roberts and Co., 40 S.E.C. 907 (1961).
[6] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 404 U.S. 1005 (1971).
[7] Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972).
[8] General Time Corp. v. Talley Industries, Inc., 403 F.2d 159 (1968), *cert. denied,* 393 U.S. 1026 (1969).
[9] 15 U.S.C. § 78m(d) (1) (1976).
[10] *See, e.g.,* Zweig v. Hearst Corp., 594 F.2d 1261 (9th Cir. 1979).

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