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Comment, Rationalizing Liability for Nondisclosure Under 10b-5: Equal Access to Information and United States v. Chiarella,

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RATIONALIZING LIABILITY FOR NONDISCLOSURE UNDER 10B-5: EQUAL ACCESS TO INFORMATION AND UNITED STATES V. CHIARELLA.

INTRODUCTION

When Congress passed the Securities Exchange Act of 1934[1] (the "Exchange Act") it created a far-reaching mechanism for regulating the sale of securities to private investors. In implementing one of the major provisions of the Act—Section 10(b)[2]—the Securities and Exchange Commission (the "Commission") promulgated rule 10b-5.[3] Rule 10b-5 is a broad anti-fraud provision that prohibits affirmative misrepresentations and half-truths in connection with the purchase or sale of a security. Although the rule does not expressly proscribe nondisclosure, and though under the common law mere nondisclosure could not form the basis for a deceit action,[4]

1. Pub. L. No. 291, 48 Stat. 881 (1934) (current version at 15 U.S.C. §§ 78a-kk (1976)). For a detailed discussion of this statute see Loomis, *The Securities Exchange Act of 1934 and the Investment Advisor's Act of 1940,* 28 GEO. WASH. L. REV. 214 (1959).

2. Codified at 15 U.S.C. § 78j(b) (1976). This provision provides that:

> 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—
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> . . . .
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> (b) To use or employ in connection with the purchase or sale of any security . . . 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 was first adopted by the Commission in May 1942. III L. LOSS, SECURITIES REGULATION 1426 (2d ed. 1961). It is presently codified at 17 C.F.R. § 240.10b-5 (1979) and states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (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 to make, the statements made, in the light of the circumstance under which they were made, not misleading, or
>
> (c) To engage in an act, practice or course of business which operates as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

For discussion of the rule, see III LOSS, *supra*, at 1421-74, VI *id.* at 3526-70; A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10b-5 (1974).

4. *See* W. PROSSER, THE LAW OF TORTS § 101 (4th ed. 1971). *See also* R. JENNINGS & H. MARSH, SECURITIES REGULATION 946 (4th ed. 1977). For other discussions of the problem of pure nondisclosure see Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information,* 121 U. PA. L. REV. 798, 802-03 (1973) [hereinafter cited as Fleischer, *An Initial Inquiry*]; Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding,* 51 VA. L. REV. 1271, 1277 (1965) [hereinafter cited as Fleischer, *Securities Trading*]; Jennings, *Insider Trading in Corporate Securities: A Survey of Hazards and Disclosure Obligations Under Rule 10b-5,* 62

both the courts and the Commission have construed it as imposing liability on purchasers and sellers for nondisclosure in certain situations.[5]

When the courts and the Commission first interpreted the scope of liability for nondisclosure under the rule, they focused on the defendant's status as a corporate insider—whether the defendant was an officer or director of the corporation whose securities were being traded—and on the type of information allegedly withheld. In later cases, the courts and the Commission expanded liability by broadening both the category of persons with a duty to disclose[6] and the nature of the information required to be disclosed.

Recently, the Second Circuit in *United States v. Chiarella*[7] abandoned an approach based on the defendant's status as an insider and held that *anyone,* whether an insider or not, who regularly receives nonpublic material information, must disclose that information or abstain from trading.[8] The court imposed this expanded disclosure obligation in order to effectuate what it saw as the federal regulatory policy of providing equal access to information necessary for investors to make reasonable and intelligent decisions.[9]

Nw. U.L. Rev. 809, 815 (1968) [hereinafter cited as Jennings, *Insider Trading*]; Koeltl & Longstreth, *Market Information Revisited,* 11 Rev. Sec. Reg. 843 (1978).

5. The courts and the Commission's willingness to impose liability for nondisclosure shows their refusal to be bound by traditional common-law elements of a deceit action in interpreting the statutory prohibition against deceit. *See, e.g.,* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied,* 394 U.S. 976 (1969) (corporate insiders had a duty to disclose information or abstain from trading); Rogen v. Illikon, 361 F.2d 260 (1st Cir. 1966) (where plaintiff, the former president of the corporation, sold his stock to the corporation and the corporation had knowledge about the revival of negotiations with a potential purchaser and about technological progress on a key project but did not reveal it to the plaintiff, held that the alleged nondisclosure raised a material fact precluding summary judgment for the defendants); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951) (controlling shareholder purchasing shares from minority stockholder had a duty to disclose the greatly appreciated inventory value which was not revealed in the annual report, and the intent to liquidate the corporation, enabling it to capture that appreciation); Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947) (defendants, directors of corporation purchasing shares from plaintiffs, had a duty to disclose fact that they had arranged for the sale to a third corporation for a price higher than the book value offered to plaintiff). *But see* List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.), *cert. denied,* 382 U.S. 811 (1975) (no duty of insider purchasing stock from minority stockholder to disclose the fact that the company had a potential purchaser on the horizon when that court concluded that plaintiffs would have sold the stock even if the information had been disclosed); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963) (no duty by the company accountant negotiating the purchase of the stock to disclose details of pension plan or accounting methoa of annuities funding to stockholder who had years of acquaintance with the company).

6. *See* Note, *SEC v. Texas Gulf Sulphur Co., The Inside and Outside of Rule 10b-5,* 46 B.U.L. Rev. 205, 210 (1966) [hereinafter cited as Note, *SEC v. Texas Gulf Sulphur Co.*].

7. 588 F.2d 1358 (2d Cir. 1978), *cert. granted,* 99 S. Ct. 2158 (1979). *See also* text accompanying notes 104-06 *infra.*

8. *Chiarella,* 588 F.2d at 1365.

9. Judge Kaufman stated that "The draftsmen of our nation's securities laws, rejecting

Chiarella was an employee of a financial printer who worked on documents for use by tender offerors. By successfully decoding the documents, Chiarella identified the parties involved and, on the basis of that confidential market information, placed orders with his broker. Notwithstanding Chiarella's noninsider status, the Second Circuit upheld his criminal[10] conviction for violating rule 10b-5.[11]

Chiarella provided the Second Circuit with an opportunity to resolve an important issue on which there previously had been no square holding:[12] whether a person who is not an insider and has no inside knowledge about the company whose securities he is trading nevertheless has a duty to disclose nonpublic material information in his possession about impending stock market events.[13] The court viewed such a person as a "market insider"[14] and found a duty to disclose. To evaluate the propriety of imposing liability in this situation, this comment will first trace the development and expansion of liability for nondisclosure under rule 10b-5. Section I concludes

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the philosophy of *caveat emptor,* created a system of providing equal access to information necessary for reasoned and intelligent investment decisions." *Id.* at 1362.

10. Chiarella contended that he could not be convicted criminally for two reasons. First, he argued that he lacked adequate notice of the conduct proscribed. In finding that Chiarella had adequate notice, the court relied partly on publicity surrounding a consent decree entered into for conduct substantially similar to Chiarella's, see SEC v. Sorg Printing Co., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,034 (S.D.N.Y. 1975), and partly on signs at Chiarella's own company prohibiting the conduct in which he later engaged, see *Chiarella,* 588 F.2d at 1369.

Chiarella's other defense to the criminal charges was that he lacked the requisite intent to support a criminal conviction. *Id.* at 1370. The Second Circuit found the necessary intent on the basis of the trial court's finding that Chiarella acted knowingly and willfully, rejecting the defendant's contention that the government had to go farther and prove a specific intent to defraud in order to support a criminal conviction. *Id.*

Although criminal liability on these facts is not very compelling, this comment will not focus on the criminal liability but on the scope of *civil* liability under rule 10b-5. Since Chiarella was not within a category of persons known as corporate insiders, on whom the courts had imposed broad disclosure duties, the initial and critical issue in the case was whether and on what grounds such persons could be liable for nondisclosure. The criminal issue, by contrast, is somewhat less interesting doctrinally. It turns on the issue of whether, assuming liability, the facts would support a criminal conviction. The comment concludes that since Chiarella's conduct clearly falls within the scope of 10b-5, he should be found to have violated 10b-5 even if the criminal conviction is ultimately reversed either for a lack of sufficient notice or of the requisite scienter.

11. Chiarella was convicted on 17 criminal counts of misuse of material nonpublic information under §§ 10(b) and 32(a) of the Exchange Act of 1934, 15 U.S.C. §§ 78j(b), 78ff(a) and rule 10b-5. After the jury convicted him on every count, the defendant moved to dismiss on the ground that no crime was charged. *Chiarella,* 588 F.2d at 1364. For a report of the district court's denial of the motion, see United States v. Chiarella, 450 F. Supp. 95 (S.D.N.Y. 1978). The appeal to the Second Circuit followed the district court's denial of the motion to dismiss.

12. *See* JENNINGS & MARSH, *supra* note 4, at 953.

13. *See* note 95 *infra.*

14. *Chiarella,* 588 F.2d at 1365.

that although most of the cases tie the duty to disclose to the defendant's insider status, they can plausibly be read in terms of an underlying regulatory principle of equal access to information. To test this hypothesis, Section I then examines cases involving outsiders who, since they owe no fiduciary duty to the shareholders of an *issuer's* securities, would have no duty to disclose absent another principle.

Section II of the comment then turns to the legislative history of the Exchange Act to determine if it supports an equal access principle. Section II finds, as did the case law prior to *Chiarella,* that legislative history fails to provide definitive support for an equal access principle. The comment concludes in Section III, however, that strong policy reasons favor adoption of such a principle.

In section IV the comment focuses on the *Chiarella* opinion, which adopted the principle of equal access and created a test to effectuate it. The comment concludes by endorsing *Chiarella's* adoption of the principle, criticizing the test adopted, proposing an alternative one for defining the scope of liability, and exploring its application in a variety of nondisclosure situations involving outsiders.

I. Status and Fiduciary Concepts and the Affirmative Duty to Disclose

A. *Introduction*

A major theme in the rule's interpretive history concerns the narrow definition of fraud as affirmative misrepresentations and half-truths—but not absolute silence.[15] Despite this literal meaning,

15. The rule by its terms imposes no penalties for mere silence. Clause (b) of the rule, see note 3 *supra,* refers to omissions to state material facts which are necessary to make statements already *made* not misleading. Thus, under a literal reading, if *no* statements are made there would be no liability. Likewise, clauses (a) and (c) covering devices, schemes or practices which are intended to defraud apparently require no affirmative disclosure. *See* Jennings & Marsh, *supra* note 4, at 946.

By defining fraud in terms of affirmative acts, rule 10b-5 followed the common law which imposes no penalties for mere silence. *See* notes 4-6 *supra* and accompanying text. *But see* note 16 *infra. See also* Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1172 (2d Cir. 1971) (where customer relied on broker's recommendation and broker failed to reveal his market maker status, the court thought the requirement of reliance properly one of tort "causation in fact"). In cases of pure nondisclosure the Supreme Court held positive proof of reliance was not required. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, *rehearing denied,* 408 U.S. 931 (1972); Mills v. Electric Auto-Lite Co., 396 U.S. 374, 384 (1970). *See also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968). For cases following the *Affiliated Ute* approach, see Cameron v. Adams Co., 547 F.2d 473 (9th Cir. 1976); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); Reeder v. Master Craft Electronics Corp., 363 F. Supp. 574, 581 (S.D.N.Y. 1974) (reliance requirement has little relevance where plaintiff bought shares on the open market).

the courts and the Commission, wishing to extend liability to those who bought or sold a security without disclosing material information, created a duty to disclose in certain situations where no affirmative misrepresentation had been made.[16]

In interpreting the scope of the rule, the courts and the Commission have predicated liabilty for nondisclosure on a fiduciary duty inherent in a defendant's status as an insider in the corporation whose securities he is trading. This doctrinal reliance on the elements of status and fiduciary duty stems from the fact that the rule was interpreted against a background of the common law,[17]

There has been a similar erosion of the requirement of privity. In Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S.D.N.Y. 1951), *aff'd,* 198 F.2d 833 (2d Cir. 1952) the court held that there must be a "semblance of privity" between plaintiff and defendant. *Id.* at 706. Two recent cases have followed the *Farnsworth* holding. *See* Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), *cert. denied,* 429 U.S. 1053 (1977); Imperial Supply Co. Profit Sharing Trust v. Northern Ohio Bank, 430 F. Supp. 339 (N.D. Ohio 1976). But several cases have allowed plaintiffs to recover as long as they could prove that they were trading during the period of the misrepresentation. Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975); Sargent v. Genesco, Inc., 492 F.2d 750 (5th Cir. 1974).

In contrast to the relaxation of the requirements of privity and reliance, some proof of scienter is generally still required. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976), where the United States Supreme Court held that some proof of scienter was an essential precondition to a civil action for damages under the anti-fraud provisions of the Exchange Act, but left open the question whether reckless conduct would be sufficient scienter for imposing liability. For cases holding that recklessness may suffice, see Sanders v. John Nuveen & Co., 554 F.2d 790 (7th Cir. 1977); Sunstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033 (7th Cir. 1977).

The erosion of the common-law elements of a deceit action as requisite for the imposition of liability is significant because it indicates that in order to effectuate the purposes of the rule, courts may be willing to relax some of the formal common law requirements. A similar pattern is reflected in the courts' willingness to go beyond strict common-law fiduciary notions and impose liability under the rule even in cases where not all the elements of a fiduciary relation are present, as in the case of corporate outsiders. *See* notes 20-61 *infra* and accompanying text.

16. Even before the Exchange Act was passed or the rule promulgated, courts occasionally interpreted the duty to disclose expansively and found liability for nondisclosure absent affirmative misrepresentations. A case in which the United States Supreme Court held that although officers and directors did not have a duty as such, but special circumstances required disclosure, was Strong v. Repide, 213 U.S. 419 (1909). In that case the Court held that where the agent purchased shares from a stockholder for a defendant who had exclusive knowledge of an impending sale to the government, the failure to disclose that information amounted to a fraud sufficient to void the sale. *Id.* at 431-32. The Commission and the courts have continued to follow *Repide* in finding a duty to disclose even in the absence of any express liability for nondisclosure. *See* text accompanying notes 20-64 *infra.*

17. It was natural for judges to look to common-law concepts, for "[s]tatutes build on the common law and, especially when statutes are new, judges and lawyers who are trained in the common law are apt to look to it for guidance." III Loss, *supra* note 3, at 1430. The courts looked particularly to the common law of the tort of deceit in developing the elements of a 10b-5 cause of action. Common-law deceit requires proof of: (1) a false representation; (2) knowledge or belief that the representation is false or the defendant's lack of a sufficient basis of information to make the representation (scienter); (3) an intention to induce the plaintiff to act or to refrain from so acting; (4) justifiable reliance by the plaintiff; and (5)

which suggested that the positions of officers and directors carry with them a fiduciary duty to the corporation[18] and to its shareholders.[19]

This section of the comment will attempt to demonstrate that, although the courts and the Commission initially defined liability or lack thereof in terms of the convenient concepts of status and fiduciary duty, a policy of equal access to material information may have provided the real ground for imposing liability.

B. *From the Inside Out: Historical Expansion of the Duty to Disclose and the Idea of Equal Access*

1. OFFICERS, DIRECTORS, AND CONTROLLING SHAREHOLDERS

The first persons whom the courts held to an affirmative duty to disclose were corporate officers and directors. In *Kardon v. National Gypsum Co.*[20] certain officers and directors of a corporation were found to have violated rule 10b-5 even though they had made no affirmative misrepresentations or half truths.

The two plaintiffs and the two defendants in the case owned all the stock in a corporation in which they were the corporate officers. Without the plaintiffs' knowledge, the defendants agreed to sell the plant and equipment to another corporation and then purchased all

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damages based on such reliance. *See* PROSSER, *supra* note 4, § 5 at 685-86.

In defining the nature and scope of of a 10b-5 fraud action, however, the courts were not narrowly bound by the common law of deceit, and gave recovery even where the plaintiff was unable to prove one or more of these elements. For example, although early cases required proof of reliance as prerequisite to recovery under rule 10b-5, see List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.), *cert. denied,* 382 U.S. 811 (1975), "[r]ecent case law supports the proposition that proof of reliance is unnecessary when the deception involves nondisclosure rather than misrepresentation." Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5,* 88 HARV. L. REV. 584, 591 (1975).

18. It made sense to impose the duty to disclose on corporate insiders, because they were likely to have access to material nonpublic information. Examples include knowledge about such specific events as a change in dividend policy, Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962); a stock split, Hafner v. Forest Laboratories, Inc., 345 F.2d 167 (2d Cir. 1965); impending liquidation of appreciated inventory, Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951); or discovery of a new mineral deposit, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968). Early courts, however, took a narrow view of the scope of the duty; officers and directors were not required to make any disclosures to stockholders, so long as they were acting as individuals. III Loss, *supra* note 3, at 1446.

19. III Loss, *supra* note 3, at 1446. *See* Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903) (holding that officers and directors had to disclose *all* material facts to prospective purchasers or sellers). *See also* Stewart v. Harris, 69 Kan. 498, 77 P. 277 (1904); Jacobson v. Yaschik, 249 S.C. 577, 584-85, 155 S.E.2d 601, 605 (1967).

Modern courts have followed the lead of these earlier cases and uniformly held that insiders are fiduciaries with a duty not only to refrain from making fraudulent statements but also to affirmatively disclose information. *See* cases cited in note 5 *supra.*

20. 73 F. Supp. 798 (E.D. Pa. 1947). For a discussion of this case see III Loss, *supra* note 3, at 1457.

of the outstanding stock held by the plaintiffs without disclosing the proposed sale. The plaintiffs argued that had they known of the proposed sale, they might not have sold their shares at the price offered by the defendants.[21] The defendants argued that the plaintiffs were not entitled to a remedy absent proof of lost profits, an element of the common law tort of deceit.[22] The court, however, rejected that argument, basing its imposition of an affirmative duty to disclose on the fiduciary obligations inherent in the defendants' insider status. The court's rejection of the lost-profits requirement[23] demonstrates a judicial unwillingness to let a common-law heritage rigidly define the boundaries of liability under rule 10b-5.

The question of whether controlling shareholders who were not officers or directors had similar fiduciary duties of disclosure was answered affirmatively[24] in *Speed v. Transamerica Corp.*[25] In

21. At the meeting at which the defendants purchased the plaintiffs' outstanding shares, the plaintiffs' attorney specifically asked whether the defendants had entered into any prior agreement for the sale of such stock. The defendants' attorney replied that no such agreement existed. The plaintiffs contended that the defendants had also denied any preexisting agreement for the sale of the company's assets. Although there was substantial dispute as to whether this fact had been disclosed, the court thought it made little difference whether the plaintiffs had expressly asked about the sale of assets since the defendants had failed to state a material fact needed to make their answer not misleading. *Kardon,* 73 F. Supp. at 801 n.1.

22. The defendants' position was that they could be held accountable as trustees only for lost profits and that, absent proof of lost profits, they had no duty to account to the plaintiffs for anything. *Id.* at 802.

23. In rejecting the necessity of proof on lost profits, the court said:

> It is not necessary that they [prove lost profits]. The plaintiffs' case was established when the defendants' duty and its breach were proved. This was done by showing that the defendants were officers and directors of Western and that they disposed of the bulk of their corporate assets to an outsider for their own benefit, without disclosing the transaction to the plaintiffs. . . .

Id. at 802. The court explained that while one might have to prove lost profits in a common-law action, such proof was not required in a 10b-5 cause of action because it would defeat the broad remedial provisions of the Exchange Act. *Id.* at 803.

24. *See* III Loss, *supra* note 3, at 1450.

25. 99 F. Supp. at 808. In one of the few other cases involving a controlling shareholder in a nondisclosure suit, James Blackstone Mem. Lib. Ass'n v. Gulf, M & O R. Co., 264 F.2d 445 (7th Cir. 1959), the court held that there was no violation of rule 10b-5 on the facts. In that case a minority shareholder alleged that the defendants had violated their fiduciary duty by failing to disclose material facts affecting the value of the plaintiffs' stock. The complaint alleged that when defendants purchased plaintiffs' shares, they failed to disclose negotiations for a sale to the United States government of certain leasehold property owned by the corporation. The plaintiffs claimed that access to that information would have affected the price at which they were willing to tender their shares. The court rejected the claim on the ground that at the time of the defendants' purchase of the plaintffs' shares, the proposed sale to the government was only a "hope." The remoteness of the sale led the court to conclude that the facts of this case were distinguishable from *Kardon* and *Speed* where the nondisclosure concerned events or conditions which were already assured at the time of the purchase. *See id.* at 450. There is, nonetheless, favorable dictum in the opinion to the

Transamerica the majority stockholder of Axton-Fisher Company made a written offer to all minority stockholders to purchase the outstanding stock. Minority shareholders brought a class action[26] alleging that in accepting the defendant's offer to purchase their shares they relied upon an annual report and letter which failed to disclose certain material information,[27] and thus constituted a breach of fiduciary duty.[28] The court concluded that the defendant's failure to disclose the company's increased earnings and his intent to liquidate violated rule 10b-5.

The court grounded liability for nondisclosure on the defendant's status as a majority stockholder, treating him as the equivalent of an insider[29]—an approach emphasizing status in the liability inquiry.[30] However, the court's reliance on the status/fiduciary duty rationale was not exclusive. The court also stated that rule 10b-5 was intended to "provide some degree of equalization of bargaining position"[31] among investors by equalizing access to information, a view which provides a broader rationale for the imposition of an

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effect that a majority stockholder of a corporation does occupy a fiduciary relation to minority stockholders and is under an obligation to disclose material facts. *Id.*

26. In their suit plaintiffs alleged common-law actions of fraud and deceit as well as violation of rule 10b-5. The complaint contained four counts. The first alleged a common-law action for fraud. The last three counts charged violations of various subparagraphs of rule 10b-5. *Transamerica,* 99 F. Supp. at 813. In counts two and three the plaintiffs alleged that the defendants' soliciting of the minority's stock violated rule 10b-5 because at the time of its mailing of the offer to purchase, the defendants had already formed the intent to liquidate the company and the failure to disclose that intention violated clauses (a) and (c) of 10b-5. *Id.* at 813-14. For the text of these clauses of 10b-5 see note 3 *supra.* In the final count plaintiffs charged that clause (b) of 10b-5 was violated by the failure to disclose improved earnings or increased inventory value. *Transamerica,* 99 F. Supp. at 814.

27. The material information consisted of information regarding the increased value of Axton Fisher, the real value of the inventory not reflected in the annual report, the improvement in earnings and the defendants' intention to liquidate. *Transamerica,* 99 F. Supp. at 812.

28. The court rejected the defendant's argument that its only duty was the negative one of refraining from affirmative misrepresentations. The court thought it a well-settled principle that "an implied misrepresentation is just as fraudulent as an express one." *Id.* at 829.

29. The court's treatment of the majority shareholder as equivalent to an insider is reflected in the following explication of rule 10b-5:

> The rule [rule 10b-5] is clear. It is unlawful for an insider, such as a majority stockholder, to purchase of minority stockholders stock without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of this *inside position* but not known to the selling minority stockholders which information would have affected the judgment of the sellers.

Id.

30. The court underlined the importance of status in its decision when it focused on the status of those having a disclosure obligation. "One of the primary purposes of the Securities Exchange Act of 1934, 15 U.S.C.A. § 789 *et. seq.*, was to outlaw the use of inside information by corporate officers and principal stockholders for their own financial advantage to the detriment of uninformed public security holders." *Id.* at 828-29.

31. *Id.* at 828.

affirmative duty to disclose. Although the court regarded insider status as an important element in assessing liability, its articulation of the "equal bargaining" principle suggested that insider status might not be an essential precondition to imposing liability. The court's reading of the rule in terms of equalizing bargaining power is significant because that principle is capable of supporting more widespread liability in the future, based on the existence of unequal bargaining power even in the absence of an insider relationship.

2. TIPPEES OF INSIDERS HELD LIABLE IN CADY ROBERTS AND CO. AND INVESTORS MANAGEMENT

Kardon and *Transamerica* interpreted rule 10b-5 as imposing on traditional corporate insiders an affirmative obligation to disclose material information. In subsequent cases the Commission and the courts broadened the rule's reach by expanding the category of persons owing a like duty. *Cady Roberts & Co.*[32] marked the first major expansion of that category. In *Cady* the Commission held that persons who had received tips from corporate insiders—tippees—could be held liable for trading on inside information.[33]

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32. 40 S.E.C. 907 (1961). One commentator viewed the *Cady Roberts* opinion as important for several reasons:

> The Commission clearly established that nondisclosure was an "act, practice or course of business" operating as a "fraud or deceit" within the meaning of clause 3 of rule 10b-5. It held that the rule could reach nondisclosure by persons who are not "insiders" at common law or by the terms of other sections of the Exchange Act, and that a duty of disclosure was owed even in sales to unidentified persons on a public exchange. The Commission also refused to consider a broker's fiduciary duty to the discretionary accounts as a defense to a 10b-5 prosecution. Finally, it disclosed for the first time an awareness of the importance of civil liability, observing that despite the decline in importance of a "federal rule" in the light of Erie Co. v. Tompkins, the securities acts may be said to have generated a wholly new and far-reaching body of federal corporation law.

Comment, *Insider Liability under Securities Exchange Act Rule 10b-5: The Cady Roberts Doctrine,* 30 U. CHI. L. REV. 121, 122 (1962) [hereinafter cited as Comment, *Insider Liability*]. *See also* VI Loss, *supra* note 3, at 3561; Daum & Philips, *The Implications of Cady Roberts,* 17 BUS. LAW 939 (1962).

Judicial recognition of the *Cady* principle of holding tippees liable under 10b-5 followed the decision. In Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967), the sellers of stock brought an action against a corporation and several of its stockholders and officers. Three of the defendants had no position in the corporation. One defendant, however, was a brother of the controlling directors and controlling shareholders. The other defendants were close personal friends of the family controlling the corporation. The defendants purchased stock from the plaintiffs at $120 per share without disclosing an intent to make a private offering of some of it at $300 per share and a public offering of the remainder at $500 per share.

The court held that these three non-officer/director defendants were liable for nondisclosure under two possible theories. First, the court stated that the defendants were insiders. But even if they were not insiders, the court was willing to hold them liable as tippees; as such they were "subject to the same duty as insiders." *Id.* at 409-10.

The extention was a logical and necessary one; otherwise directors and officers could easily evade the prohibitions against insider trading merely by furnishing the information to relatives and other third parties.[34]

In *Cady,* the Commission instituted a disciplinary proceeding against a partner of a broker-dealer firm who, after receiving nonpublic information about a prospective cut in an issuer's dividend[35] from an associate in his firm, sold stock for discretionary accounts.[36] The associate obtained the information by virtue of his membership on the issuer's Board of Directors. The Commission held that the partner's sales, made before the information became public, violated the Exchange Act.

In *Cady* the Commission based its finding of liability for nondisclosure in part on the defendant's status. The Commission reasoned that because the defendant had special access to an insider who would clearly have been obligated to disclose the information had he traded on it himself,[37] the defendant, as the insider's tippee, had equivalent responsibilities.[38] Because it framed the inquiry in

33. In an early case the SEC had reached a similar result in a disciplinary proceeding against a broker-dealer who had submitted bids on the basis of inside information he had derived from a corporate employee of the issuer. In *In re* Honohan, 13 S.E.C. 754 (1943), the broker-dealer had an arrangement whereby he was able to get information on the sealed bids that bondholders had made to sinking funds. That information was not available to other broker-dealers. With that nonpublic information he was able successfully to underbid the other bondholders. The Commission found him, as a tippee of a corporate employee, liable for violating rule 10b-5. *Id.* at 758.

34. One author notes that "Whatever duty of disclosure Rule 10b-5 imposes upon officers, directors and controlling persons could be readily bypassed if the same duty were not held to devolve at least upon members of their immediate families." III Loss, *supra* note 3, at 1450. *See also* Note, *SEC v. Texas Gulf Sulphur Co., supra* note 6, at 212.

35. During 1959 Curtiss-Wright had paid a dividend of $.625 per share for each of the first three quarters of the year. In the fourth quarter the company decided to pay a reduced dividend at the rate of $.375 per share. For a discussion of the importance of dividend information and its possible effect on the market cut, see Fleischer, *An Initial Inquiry, supra* note 4, at 799 n.5.

36. Upon receiving the information Gintel, the partner, executed a solicited order and sold shares for a discretionary account. He executed these orders at 11:15 a.m. and 11:18 a.m. when the price of the stock was at 40¼ and 40⅜. At 11:48 a.m. when the news of the dividend cut was announced, there were so many sell orders that the Exchange was forced to suspend trading in the issuer's stock.

37. The Commission stated that 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 . . . ." *Cady,* 40 S.E.C at 912. For the second prong of the Commission's test, see text accompanying note 42 *infra.*

38. "The facts here impose on [the defendant] the responsibilities of those commonly referred to as insiders." *Cady,* 40 S.E.C. at 912. In its early interpretation of rule 10b-5, however, the Commission had taken a restrictive view of the liability of tippees under the rule. The Commission's narrow reading of the scope of the rule is reflected in the following opinion:

status terms, the Commission was primarily concerned with determining whether the defendant enjoyed a special relationship to an insider, giving him access to information not otherwise available.[39]

The Commission in *Cady,* however, recognized that status should not be the exclusive determinant of liability.[40] Although courts had previously imposed liability only when defendants fell into certain predefined categories of persons,[41] the Commission now stated that liability could also be based on "inherent unfairness involved where a party takes advantage of such information [intended only for a corporate purpose] knowing it is unavailable to those with whom he is dealing."[42] The concern here was fair and honest securities markets. The Commission's recognition that such a goal was within the purpose of rule 10b-5 suggests that the rule could be interpreted so as to hold a defendant liable for nondisclosure regardless of his status. However, the *Cady* decision itself did not go so far, for it clearly tied the disclosure duty to the existence of a relationship with an insider.[43]

Another aspect of the *Cady* decision, however, gives added credence to the view that market fairness falls within the ambit of 10b-5 purposes. In *Cady* the Commission extended liability under the rule to purchases as well as sales of securities.[44] The common law imposed a duty of disclosure on insiders only for purchases[45] of issuer

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> [An] insider could communicate to an outsider the same information he knows, and the outsider might act on it, and unless the Commission had evidence from which they could conclude that the insider was a party in fact to the transaction, either acted in concern [sic] with or conspiracy with the outsider, I do not think that they would hold the outsider as being in violation of rule x-10b-5. . . .

Hearings before Subcomm. of the House Comm. on Interstate and Foreign Commerce, 82d Cong., 2d Sess. 726 (1952), cited in Note, *Deterrence of Tippee Trading Under Rule 10b-5,* 38 U. Chi. L. Rev. 372, 380 (1971).

39. "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 as trading in its securities. Intimacy demands restraint lest the uninformed be exploited." *Cady,* 40 S.E.C. at 912.

40. The willingness to extend the disclosure obligations was based in part on the Commission's refusal to be circumscribed by fine distinctions and rigid classifications. *Id.*

41. The Commission acknowledged that three groups—officers, directors, and controlling shareholders—had previously been held liable, but now stated that these groups "do not exhaust the category of persons upon whom there is such an obligation." *Id.*

42. *Id.*

43. *See* note 39 *supra.*

44. One commentator recognizes the difficulty of finding a duty to disclose when the transaction involves a sale rather than a purchase of a security by corporate insiders. This is because before the sale the buyer is not a shareholder of the issuer, and so the insider owes him no duty to disclose material information. *See* Fleischer, *Securities Trading, supra* note 4, at 1279. Loss, in treating the subject of insiders' sales, states that "[T]he argument, of course, is that an insider who sells to a person who is not already a security holder is not a fiduciary whatever his status when he buys." III Loss, *supra* note 3, at 1454-55.

45. "Whatever distinction may have existed at common law based on the view that an

stock; no such duty attached to sales because the fiduciary relationship between the insider and the buyer arose only after the sale was completed. The Commission rejected this distinction between defrauded buyers and sellers on policy grounds. It found that the approach was too narrow—that it "ignores the plight of the buying public wholly unprotected from the misuse of special information,"[46] and that it was inappropriate in light of the purposes of the Exchange Act.[47] The significance of the Commission's finding that rule 10b-5 created a cause of action for defrauded purchasers lies in its demonstration of the decreased role which common-law fiduciary notions were playing in the determination of liability for nondisclosure.[48] Moreover, in rejecting all of the defendant's arguments against an extension of the remedy to both purchasers and buyers, the Commission was apparently motivated by a desire to protect the public from the misuse of special information. The Commission went out of its way to find liability, distinguishing the cases proffered by the defendant and rejecting the defendant's suggestion that the mere absence of manipulation would immunize him if the transaction were not a face-to-face one. The Commission refused to be bound by what it regarded as "artificial walls of responsibility."[49]

The Commission in *Cady* felt compelled to tie tippee liability back to insider status; in this regard its approach was a narrow and

officer or director may stand in a fiduciary relationship to existing stockholders from whom he purchases but not to members of the public to whom he sells, it is clearly not appropriate to introduce these concepts into the broader anti-fraud concepts embodied in the securities acts." 40 S.E.C. at 913-14.

46. *Id.* at 913.

47. *Id.* at 914.

48. Two other theories, both less important from the standpoint of this comment, may explain the court's willingness to extend liability. The first theory is that although insiders do not stand in a fiduciary relationship to the defrauded buyer at the time of the transaction, the sale itself imposes the same obligations which inhere in a fiduciary relation. As Judge Learned Hand stated in an opinion affirming the constitutionality of § 16(b) of the Exchange Act, "When [directors or other corporate officers] sold shares, it could indeed be argued that they were not dealing with a beneficiary, but with one whom his purchase made a beneficiary. That should not, however, have obscured the fact that the director or officer assumed a fiduciary relation to the buyer by the very sale. . . ." Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir.), *cert. denied,* 341 U.S. 920 (1951).

The other theory proposed to explain extension of the remedy to defrauded buyers is that buyers expect the offer price to represent the insider's reasonable judgment as to a fair price. *See* III Loss, *supra* note 3, at 1457. As one comentator explains, "The federal securities laws like fraud doctrine generally, may be interpreted to impose a duty of disclosure if the expectation of the market place necessarily contemplates such a requirement." Fleischer, *Securities Trading, supra* note 4, at 1279. *See also* Prosser, *supra* note 4, § 108 at 714-18; Keeton, *Fraud—Concealment and Non-Disclosure,* 15 Tex. L. Rev. 1, 31-34 (1936). Moreover, the Commission in *Cady* could see no logical reason for restricting recovery to defrauded sellers. The Commission said that "[T]here is no valid reason why persons who purchase stock from officers should not have the same protection afforded to them." 40 S.E.C. at 913.

49. *Cady,* 40 S.E.C. at 913.

mechanical one. In *Investors Management Co.*,[50] however, the Commission took a less mechanical approach to the problem of tippee trading. In that case it indicated that it might impose liability for nondisclosure simply on the basis of *possession* of material nonpublic information,[51] regardless of the defendant's status as an insider or an insider's tippee[52] and regardless of whether the information emanated from an *issuer* source.[53]

In *Investors Management* several defendants[54] received nonpublic information concerning a drop in per-share earnings and projected earnings[55] from a broker-dealer whom they knew was the prospective managing underwriter of a forthcoming public offering of Douglas Aircraft debentures. After receiving that information, the defendants sold Douglas stock[56] without revealing to the purchasers their nonpublic information. The Commission held that such conduct constituted a violation of the antifraud provisions.[57]

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50. Sec. Exch. Act. Rel. No. 9267. Inv. Adv. Act. Rel. No. 289 (July 29, 1971) [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,163.

51. W. PAINTER, FEDERAL REGULATION OF INSIDER TRADING 143 n.9 (1978 Supp.) states, "Some recent discussions of tippee liability have taken what might be termed a strict approach to the problem. Essentially this defines a tippee as anyone in possession of material undisclosed information regardless of how he learned of such information."

52. The Commission focused on the fact of possession of undisclosed information because that possession put the recipient in a superior position. *See* text accompanying note 60 *infra.*

53. *See* text accompanying note 61 *infra.*

54. These defendants consisted of investment partnerships, institutional advisers, and mutual funds. *Investors Management,* [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,163 at 80,514.

55. The issuer had informed its prospective underwriter, Merrill Lynch, of the reduced earnings and earnings forecasts on June 20, 1966. Specifically, Douglas indicated that it had suffered a loss in May, that earnings for the first half of 1966 would amount to only 49 cents per share and that its projections indicated it would break even for the year as a whole; the outlook for 1967 was not much better, with earnings estimated at $5-6 per share. *Id.* ¶ 78,163 at 80,515.

Although it was proper for the issuer to disclose such information to its managing underwriter to enable the managing underwriter to make a sound business judgment about the forthcoming offering, the managing underwriter was not entitled to disclose that information to other firms for a noncorporate purpose. *Id.* ¶ 78,163 at 80,521.

56. Between June 21 and June 23 the respondents, who had been tipped by Merrill Lynch, sold almost all of their Douglas stock and effected some short sales as well. The price at which they sold ranged from 90 to 90 ½. On the day following the public announcement of reduced earnings, the stock price fell to 76. *Id.* ¶ 78,163 at 80,516.

57. The examiner found that the respondents had violated 17(a) of the Securities Act of 1933 as well as 10(b) of the Exchange Act and rule 10b-5. *Id.* ¶ 78,163 at 80,515.

In its opinion the court defined the elements required for such liability. First, the information must be material and nonpublic. The information was material since it "was of such importance that it could be expected to affect the judgment of investors whether to buy, sell or hold Douglas stock. . . ." *Id.* ¶ 78,163 at 80,515 (citing Merrill Lynch, Pierce, Fenner & Smith, Inc., Sec. Exch. Act. Rel. No. 8459, at 5 (November 25, 1968)). The information was nonpublic since it had not been generally disseminated to the public: "[I]nformation is nonpublic when it has not been disseminated in a manner making it available to investors

Investors Management expanded liability even further than had *Cady,* by holding the defendants liable not on the basis of a special access to an insider but on the basis of the mere receipt of nonpublic information.[58] The court held that receipt of such information by one who has reason to know[59] that it emanates from a corporate source when the information puts one in a position superior to that of other investors, triggers application of the antifraud rules[60] and the duty to disclose.

Through this formulation the Commission evidenced a concern with the use of nonpublic information which puts others at a disadvantage—and thus, with equal access. The Commission did not go

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generally." *Id. Investors Management,* [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,163 at 80,519. *(See also Texas Gulf Sulphur,* 401 F.2d at 854: "Before insiders may act upon material information such information must have been effectively disclosed in a manner sufficient to insure its availability to the investing public."). The commission recognized that during 1966 there had been some rumors circulating indicating a pessimism about Douglas' earnings. In addition, at a luncheon held on June 22 attended by about 50 professional investors, there were rumors of disappointing earnings. The Commission found that neither the general rumors nor those circulating at the luncheon constituted public dissemination. First, the information conveyed to the respondents was of a more specific kind than could previously have been known. The Commission implied that until the specific information available to the respondent was disclosed to the public, there was no public dissemination. The mere fact that rumors had been circulated was not an adequate substitute. The Commission also rejected the argument that the information was largely in the public domain by virtue of the luncheon meeting. That kind of a meeting, consisting of a limited number of investors, was not the kind of public disclosure required to put other investors in an equal position in the marketplace. *Id. Investors Management,* [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,163 at 80,520.

The second element of liability is that the tippee must know or have reason to know that the information was improperly obtained. Finally, the information must be a factor in the decision to effect the transaction. The Commission found all three elements present.

58. This argument was based on the analysis in *Cady.* There the court analyzed the obligation to disclose in terms of the "existence of a relationship giving access, directly or indirectly, to the information intended to be available only for a corporate purpose. . . ." *Cady,* 40 S.E.C. at 912.

59. The Commission held that actual knowledge of the source of the information or its nonpublic character was not required, rejecting the defendants' argument that in order to establish a violation it must be shown that the defendant actually knew that there had been a breach of fiduciary duty in the disclosure of the information. *Investors Management,* [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,163 at 80,520. The appropriate test, the Commission held, "is whether the recipient knew or had reason to know that the information was nonpublic and had been obtained improperly by selective revelation or otherwise." *Id.*

The Commission indicated that this test would impose a responsibility to disclose in some situations but not in others. The Commission stated that "[o]ur formulation would clearly attach responsibility in a situation where the recipient knew or had reason to know the information was obtained by industrial espionage and commercial bribery or the like . . . . Our test would not attach responsibility with respect to information which is obtained by general observation or analysis." *Id.* ¶ 78,163 at 80,519 n.18. The Commission's test is useful in ensuring that financially sophisticated investors will not be penalized by a skillful use of information that is generally available to all. *See* note 95 *supra.*

60. *Investors Management,* [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,163 at 80,520.

so far as to base liability on receipt alone (nor therefore, by implication, on equal access alone), but rather required an additional showing that the information emanated from a corporate source.[61]

The corporate source standard may be a meaningful variant of the previously applied issuer source standard if the Commission is implying that the corporate source could be a non-issuer source. If one assumes that the Commission intended this broader meaning, then even those having a more remote relationship to the issuer—tippees of tippees—could be liable for nondisclosure. However, as is more likely, even if the Commission used the term "corporate" as meaning "issuer," the formulation still represents a change in its increased concern with information which advantaged one investor at the expense of another and thus with equal access.

3. OUTSIDERS HELD LIABLE TO DISCLOSE IN CERTAIN CIRCUMSTANCES

In order to test how far courts are willing to extend liability, and whether defendant's status as an insider or a tippee of an insider is wholly determinative, it is important to examine the leading case in which the Supreme Court held an outsider liable for nondisclosure. If an outsider has a duty to disclose, it may show that insider status is not wholly determinative of liability and indicate that there is an underlying principle to support liability without regard to status.[62]

Courts have been leery of extending liability to outsiders.[63] But

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61. We consider that one who obtains possession of material, nonpublic information which he has reason to know emanates from a corporate source, and which by itself places him in a position superior to other investors, thereby acquires a relationship with respect to that information within the purview and restraints of the anti-fraud provisions.

Id. ¶ 78,163 at 80,520. At one point in the decision, however, the Commission comes close to adopting a rule based on possession alone. The Commission indicated that if the recipient knows the information is nonpublic, that alone should be enough of a basis for imposing liability:

> Consideration of both fairness and effective enforcement demand that the standard as to requisite knowledge be satisfied by proof that one recipient had reason to know of the nonpublic character of the information, and that it not be necessary to establish actual knowledge of that fact or, as suggested by the respondents, of a breach of fact or, as suggested by the respondents, of a breach of fiduciary duty.

Id. ¶ 78,163 at 80,520.

62. In spite of a general unwillingness to extend liability to outsiders, courts have been more willing to hold an outsider liable for nondisclosure in an SEC enforcement proceeding than in an action brought by an issuer. Two factors may explain that difference. First, a court may be unwilling to intervene in an issuer-initiated suit because it may fear that the issuer is merely trying to use the alleged nondisclosure to escape a bad bargain. Second, a court may feel that the issuer does not need the outsider to disclose because it is likely to have access to the information allegedly wrongfully withheld.

63. In Frigitemp v. Financial Dynamics Fund [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,323 (2d Cir. 1975), the court rejected the 10b-5 claim brought by an

in *Affiliated Ute Citizens v. United States*[64] which involved neither insiders nor tippees, the court found liability. In *Affiliated Ute* the disputed trading was peculiar because it was affected by the existence of a federal statute, the Ute Partition Act, which attempted to divide tribe assets between full and mixed blood members. Under the Act the mixed bloods organized the Ute Distribution Corp. (UDC) to distribute assets to half-bloods. The mixed bloods were restricted in their ability to dispose of the stock since they had to give the right of first-refusal to full-blood members. To facilitate distribution of the assets and provide for central control over the stock, the mixed bloods designated a bank as the UDC stock transfer agent in which capacity it held the stock certificates and issued receipts. In administering the scheme two bank employees started buying shares from mixed bloods in order to resell the stock to whites at higher prices in contravention of the bank's duty to prevent such sales. The mixed bloods brought a suit against the employers for 10b-5 violations.

Affiliated Ute is significant because it evinces the Supreme Court's willingness to impose liability on non-insiders for a failure to disclose market information, thus demonstrating that the judgment of the Second Circuit in *Chiarella* did not represent a radical departure from prior interpretations of 10b-5. *Affiliated Ute* also illustrates the continuing inarticulation of the underlying principle which impelled the Court to find liability: the need to achieve equal access to information. Instead the Court emphasized the particularity of the factual circumstances in the "market maker" relationship defendants had to plaintiffs which gave rise to a duty to disclose. However, the emphasis on market maker status obscures the reason why the court attached importance to that fact: the inequality in access to information which the relationship created. In articulating the basis on which liability had been continually expanded to new categories of persons in new factual situations, the Second Circuit in *Chiarella* did what no court had been willing to do before.

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outsider/purchaser against an issuer for nondisclosure of information on the grounds that outsiders—unlike insiders or controlling shareholders—owed no duty to disclose. *Id.* ¶ 95,323 at 98,633-34.

Another case in which the court exempted an outsider from disclosure obligations is General Time v. Talley Industries, 403 F.2d 159 (2d Cir. 1968). In that case a target company brought a suit against a tender offeror for its failure to disclose its intent to merge or acquire the issuer. The court rejected the claim, saying that it knew of no law or principle requiring a non-insider/purchaser to disclose such information. *Id.* at 1164.

64. 406 U.S. 128 (1972).

II. Legislative History and the Principle of Equal Access

Since the cases do not expressly support the principle of equal access, it may be useful to examine the congressional purposes underlying the Exchange Act to determine how far the scope of civil liability extends under the Act and whether its policies support liability for nondisclosure when the equal access principle is violated. This section of the comment will demonstrate that the legislative history suggests an underlying concern with equalizing access to information but fails to provide very specific guidelines for determining what circumstances would constitute actionable violations of that principle.

Congress passed both the Securities Act of 1933[65] and the Exchange Act[66] in response to abuses in stock exchange transactions which it felt had precipitated the 1929 crash and contributed to the ensuing depression.[67] From 1932 to 1934 the Senate Committee on Banking and Currency inquired[68] into stock exchange practices. In 1934 the subcommittee issued a final report documenting various abuses,[69] including the excessive use of credit,[70] inadequate disclosure[71] by issuers of listed securities, and short swing profits made by officers and directors in their own companies' securities.[72] The Exchange Act adopted a variety of legislative provisions to address these abuses.[73]

Although none of the particular provisions of the Act provides explicit support for the principle of equal access, several sections implicitly support that notion. Section 16, for example, addresses

65. 48 Stat. 74 (1933) (current version at 15 U.S.C. §§ 77a-aa (1976)). *See* Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29 (1959).

66. For sources discussing the background of the Act, see note 1 *supra*.

67. *See* Painter, *supra* note 51, at 2; Landis, *supra* note 65, at 30; Loomis, *supra* note 1, at 216-17.

68. *See* Painter, *supra* note 51, at 1.

69. *See* Loomis, *supra* note 1, at 217.

70. The Exchange Act instituted a system of credit controls to prevent recurrence of abuses. *See* 48 Stat. 886 (1934) (currently codified at 15 U.S.C. § 78(g) (1976)); 48 Stat. 881 (1934) (currently codified at 15 U.S.C. § 78(a), (b) (1976)); 49 Stat. 704 (1935) (currently codified at 15 U.S.C. § 78(h) (1976)). Under §§ 7 and 8 of the Exchange Act, the Federal Reserve Board was authorized to set margin requirements in the trading of securities to prevent excessive speculation. *See* Senate Comm. on Banking and Currency, *Stock Exchange Practices*, S. Rep. No. 1455, 73d Cong., 2d Sess. (1934).

71. *See* text accompanying notes 77-80 *infra*.

72. *See* text accompanying notes 74-76 *infra*.

73. *See* Loomis, *supra* note 1, at 218. To deter such trading the Act provides for a "three fold scheme of deterrence," with section 16(a) of the Act requiring reporting by certain officers of changes in beneficial ownership, section 16(b) providing for a disgorgement of profits earned from the purchase (or sale) of a security within six months of its sale or purchase, and section 16(c) proscribing any short sales by certain insiders and 10% stockholders. *See* Loomis, *supra* note 1, at 228-29.

the problem of insider trading. Under section 16(a) officers, directors, and beneficial owners of more than ten percent of any class of stock are required to report changes in their holdings.[74] Section 16(b) provides that profits derived from insider trading inure to the benefit of the corporation rather than to the individual trader.[75]

Each of these subsections of section 16 can be explained in part as an effort to equalize the relative position of the corporate insider *vis-á-vis* the average investor by equalizing their access to material information. For example, by requiring officers, directors, and ten percent beneficial owners to report changes means that those persons most likely to have access to inside information cannot dispose of their stock without publicly disclosing that they have done so. If an officer is privy to information which warrants a sale or purchase of issuer stock, others will thus be advised of the existence of such facts through reports of the sale. Although this requirement alerts stockholders to the possible existence of facts affecting the value of the stock only after the insider's transaction has occurred, and therefore still leaves them at a disadvantage, the other sections of section 16 serve further to equalize their relative positions. Section 16(b)'s disgorgement requirement—which deprives insiders of the benefit of their special access to nonpublic information about the issuer by prohibiting personal profit thereby—may effectively reduce instances of trading in which a substantial disparity of information exists. The prohibition against retaining the profits from short swing sales can foster more equal access to information. By requiring persons having special access to information to retain securities purchased from their own company for a minimum of six months, the law provides a lag time during which the nonpublic information which prompted the insider to buy may become public. The provision thereby reduces the likelihood that informational disparities will exist at the time the insider sells his stock, and insures more equal access to key information.[76]

In addition to the above provisions, the Exchange Act requires issuers of listed securities to file periodic reports with the Commission and the Exchange on which the stock is listed.[77] These reporting

74. 15 U.S.C. § 78p(a) (1976).

75. *Id.* § 78p(b) (1976).

76. Of course, after the information becomes public, the price may have drastically increased. The insider who bought cheap *before* the information was available can still profit after six months have elapsed by cashing in after disclosure. However, this provision can still reduce unfairness resulting from informational disparities at the time the investor *sells* his shares.

77. *See* 15 U.S.C. § 78m (1976). Exchanges are institutions where securities are bought and sold based on bids and offers from the entire country. There are commonly two operative restrictions: Only members of the exchange can effect floor trades, and only securities listed

requirements may also be explained in terms of the principle of equal access to information. The requirements ensure that the average investor will have greater access to information about the issuer than was available before the passage of the Act.[78] That access reduces the disparity in information between the insider and the average investor. Moreover, Congress indicated that a desire to equalize access to information among investors underlay these reporting requirements. The House Committee on Interstate and Foreign Commerce stated: "The reporting provisions of the proposed legislation are a very modest beginning to afford that long-denied aid to the exchanges in the way of securing proper information for the investor."[79] The House report continued: "The possession of these facts has for a number of years been the exclusive prerequisite of powerful banking and industrial groups. Making these facts generally available will be of material benefit and guidance to business as a whole."[80]

One other provision of the Exchange Act may reflect an underlying concern with equal access to information—the requirement that national exchanges register with the Commission.[81] That provision was designed to convert the exchanges from private clubs to public institutions.[82] It is at least arguable that one of the risks to the public from an exchange functioning as a club would be its tendency to benefit members at the expense of the investing public. Members of such clubs may have had access to information not generally available. Registering the exchanges provides for oversight of their practices. Under such close scrutiny it is doubtful that an exchange could continue to operate for the benefit of a small and sophisticated elite group of investors.

These specific provisions of the Exchange Act are useful in underscoring a broad congressional concern to make more informa-

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on the exchange may be traded. *See* Loomis, *supra* note 1, at 215.

78. Of course, the required filing of periodic reports does not guarantee an equality of access to information among all investors. It might be argued that if Congress in fact sought parity of information in enacting the registration requirements, it would have gone further and required full disclosure in such reports of all inside information, and not confined the disclosure obligations to limited types of information. However, it would be at least as compelling to say that in limiting disclosure requirements, Congress was not undermining a commitment to equal access; rather, it felt that total disclosure was not required to ensure that investors had opportunities comparable to those of insiders to profit in the market.

79. H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934).

80. *Id.*

81. *See* 15 U.S.C. § 78f (1976).

82. "The bill proceeds on the theory that the exchanges are public institutions which the public is invited to use for the purchase and sale of securities listed thereon, and are not private clubs to be conducted only in accordance with the interests of its members." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 15 (1934), cited in Landis, *supra* note 1, at 221.

tion available to a large group of investors. Thus the legislative history, like the case law, suggests support—albeit inexpress—for a principle of equal access. Neither, however, provides clear reasons in policy for imposing liability based on that principle. The comment therefore turns to the problem of justifying the equal access principle in light of the goals of the Exchange Act and the case law.

One could justify the equal access rule on moral grounds—that it is somehow "wrong" for some investors to have special access to information.[83] That explanation, however, does not seem to satisfactorily explain the case law or legislative history. If moral outrage was a sufficient explanation for the courts' expressed and implied concerns with equal access, they would have imposed liability whenever the defendant's conduct offended their moral sensibilities and would have dispensed with the elaborate justifications for liability based on status and duty. Although the importance of a moral concern cannot be discounted in light of the repeated references to achieving fairness,[84] it seems that Congress was concerned more with the public's *perception* of fairness than with fairness in an *absolute* sense, since it was the perceived fairness or unfairness that would impact most on investor confidence.

Moreover, even if equal access can be theoretically justified on moral grounds, morality is not especially helpful in effectuating the goal of equal access. Since morality-based prohibitions are likely to be felt as arbitrary due to the inherently subjective value judgments involved, such prohibitions will be resisted.[85] Thus, to effectuate the equal access goal, other policy justifications should be explored.

III. Policy Reasons for Adoption of Equal Access: The Equality of Opportunity

Several policies could be advanced in support of the principle of equal access to information. This section will demonstrate that the policy of equal opportunity among the investing public best explains the development of the case law and the drafting of the Exchange Act. The identification of equal opportunity among investors as the principal motivating factor behind equal access is also important because it provides a principled basis for limiting the scope of liability for nondisclosure.

Equal access could also be justified as a means of assuring an equality of profits among investors. Under this view the law would

83. *See* Schotland, *Unsafe at Any Price: A Reply to Manne; Insider Trading and the Stock Market*, 53 Va. L. Rev. 1425, 1430 (1967).

84. *Id.* at 1438. *See* 15 U.S.C. §§ 78(d), 1(b)(2), 1(b)(3), m(a), s(b) (1976).

85. *See* Schotland, *supra* note 83, at 1426.

guarantee equal access to information because without it some investors will profit at the expense of others. Thus, if *A* has access to nonpublic information about an impending tender offer and *B*, a shareholder of the potential target company, does not, *A* should be required to abstain from purchasing *B*'s shares in the target company. Otherwise, *B* will tender his shares at a lower price than he would if he were aware of *A*'s undisclosed intention to make a tender offer.

Several reasons militate against recognizing a policy in favor of a certain distribution of profits among traders. First, that policy interferes with the free play of market forces by setting arbitrary limits on profits.[86] Moreover, making the determination of disclosure obligations turn on who receives what amount of the profits appears to have little support in the case law or the Exchange Act. The fairness of the transaction, rather than ultimate distribution of profits, appears to provide the occasion for imposing liability. Third, a policy based on a relative equality of outcome is troubling because it could proscribe trading by financially sophisticated investors who, even though they have no information about the issuer that is not generally available to others, are likely to achieve greater profits than the average investor. There seems to be no logical justification for penalizing investors who simply happen to be more skilled in using generally available information.[87]

The policy most strongly favoring equal access—and the one that probably motivated Congress in its enactment of section 10b—was the goal of assuring equality of opportunity among all investors. An equal chance to realize market profits appears to be essential for achieving the primary congressional goals of renewed investor confidence[88] and vigorous capital markets.

If a well-informed investor merely fails to achieve a certain level of profits, his overall confidence in the market is not likely to be impaired. He may decide to alter his investments or to seek better investment advice, but will probably continue to participate in the market. However, if an investor feels that others, either because of their position as insiders or because of a strategic position in the

86. *Chiarella*, 588 F.2d at 1367.

87. In fact, there is no restriction on the use of public information by financially sophisticated investors. *See* note 95 *infra*.

88. H. R. Rep. No. 1383, 73d Cong., 2d Sess. (1934): "If investor confidence is to come back to the benefit of exchanges and corporations alike, the law must advance." *Id.* at 5. In its discussion of the need to control unfair practices by corporate insiders, the report emphasized congressional concern with restoring investor confidence. A renewal of investors' confidence in the exchange markets can be effected only by a clearer recognition upon the part of the corporate managers of companies whose securities are publicly held of their responsibilities as trustees for their corporations. *Id.* at 13.

market, regularly enjoy access to information that is not available to him or to other ordinary investors, he may develop a sense of unfairness in the functioning of the markets and may decline to participate. Although he may be unhappy when, in the ordinary course of things, he suffers a loss in his investments, if he senses that insiders profit because of special access to knowledge that he is denied, he may be unwilling to accept the loss with equanimity.[90] If he senses that his failure to match their profits cannot be explained by chance or his lack of investment sophistication, his sense of unfairness may sharpen to the point where he withdraws entirely.

The courts and the Commission have recognized this problem by interpreting section 10b as a limitation on insider exploitation of special knowledge. Although there have been far fewer cases involving nondisclosure when the person trading is an outsider, the same limitations should be applied in such contexts. If an outsider happens to enjoy access to nonpublic information of a kind that is likely to affect the market value of an issuer's securities, the investor without access to that information is likely to experience a similar sense of unfairness when he buys stock from or sells it to such a person as when he sells to an insider.[91]

Equal access to material information thus seems necessary to achieve the primary congressional goals of investor confidence and fairness. The principle has another advantage as well: it would encourage a case-by-case analysis of liability of potential defendants' nondisclosure of nonpublic information. The "status" inquiry of the of the early case law—tying the duty of disclosure to the defendant's status as an insider or a tippee of an insider—precludes analysis of whether outsiders should be subject to the disclosure duty, and is thus of limited usefulness. Although it may lead to acceptable results when the potential defendant falls into a certain class of persons, in other cases where the potential defendant is not a tradi-

89. Congress wanted to preserve and strengthen the capital markets by preventing a recurrence of the abuses which had led to the pre-1929 situation. "This bill seeks to save, not destroy, stock markets and business, by making necessary changes in time." *Id.* at 3.

90. *Schotland, supra* note 83, at 1451. Although when considered in isolation an investor's decision not to participate may not seem significant, if other investors share this sense of unfairness and they also decline to participate, investor confidence as well as the strength of the capital markets may be impaired. Thus, the principle of equal access raises a concern broader than whether one investor rather than another profits.

91. For example, suppose an employee of the Pentagon knows that the government is going to award a contract on the following day to one of several competing companies. See JENNINGS & MARSH, *supra* note 4, at 952. With the benefit of the information, the employee purchases stock from a shareholder of the winning bidder. Although the would-be defendant is an outsider, if such a transaction occurs frequently, the investor's sense of unfairness likely will equal that experienced when he has knowledge that insiders are exploiting their position in the company to his disadvantage.

tional insider the status approach may lead to undesirable results. Application of the equal access principle would permit courts to impose liability on outsider defendants in a wider variety of circumstances than the traditional approach allows. Since outsiders may occupy a strategic position through which they acquire material nonpublic information, a principle which allows a court to hold such a person liable seems desirable.

IV. Application of the Equal Access Principle: Chiarella's "Regular Receipt" Test and a Proposed Alternative

As discussed in the preceding sections, the courts and the Commission have grappled with defining the scope of liability for 10b-5. The most difficult problems have arisen in connection with the issue of outsiders' liability. The Second Circuit in *United States v. Chiarella*[92] has recently adopted the principle of equal access to information and a test based on the regular receipt of market information as means of defining the scope of liability for outsider trading. Under the Second Circuit's view, there should ideally be equality of access to all material information. Absent such access, an outsider in receipt of market information becomes a "market insider" and shares the corporate insider's or tippee's duty to disclose or refrain from trading.

A. *What Test for Equal Access?*

1. The Chiarella Approach

Equal access as the governing principle of the case law and of congressional legislation is not novel; as has been shown in sections I and II of this comment, the Second Circuit has only recognized what was embodied inexpressly in the continued expansion of liability under the case law and in the legislative history and policies of the Exchange Act.

Although equal access is the most explanatory and appropriate principle, its application may be problematic because it is a vague and general concept. Strict adherence to the principle could result in proscription of otherwise desirable trading. However, one can endorse the principle without requiring literal adherence to it. Although Congress evinced a concern with equalizing the bargaining position of the parties through equalizing access to information, that policy cannot be considered in a vacuum; it must be viewed in conjunction with the congressional goal of allowing tender offers to

92. 588 F.2d 1358 (2d Cir. 1978), *cert. granted*, 99 S.Ct. 2158 (1979).

proceed so long as there is compliance with certain disclosure requirements. Therefore, it is appropriate to seek a test implementing the equal access principle which simultaneously limits its application in light of Congress' desire to foster certain economic activity.

To meet the difficulties inherent in applying a vague principle and thus provide guidelines for the application of equal access, the Second Circuit devised a test proscribing trading by those who regularly receive market information[93] and who thus make up a class of "market insiders."[94]

The information which Chiarella failed to disclose can be characterized as "market information" because it consisted of information affecting the price of the securities based on knowledge of impending stock market events rather than information concerning the issuer's assets or earning power.[95] Although the test appropriately expands the category of persons having a duty to disclose and the type of information required to be disclosed, in a sense it is

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93. *Id.* at 1365.

94. *Id.* at 1358.

95. *Chiarella*, 588 F.2d at 1365 n.8; Fleischer, *An Initial Inquiry*, *supra* note 4, at 798. Jennings, *Insider Trading, supra* note 4, at 810; Ruder, *Corporate Disclosures Required by the Federal Securities Laws: Codification Implications of Texas Gulf Sulphur,* 61 Nw. U.L. Rev. 872 (1967).

Generally, market information is classifiable according to either the nature or the source of the information. If defined according to the latter, it means information from a nonissuer source. Chiarella's information would meet this definition since he acquired his knowledge from the acquiring company and not from the target-issuer. If defined according to the nature of the information, market information concerns events affecting the market value of the company's securities rather than their intrinsic worth. Under this definition, market information could emanate from an issuer source. However, information affecting the market for a company's securities is more likely to have an outside source. *See* Koeltl & Longstreth, *supra* note 4, at 844. *See also* Oppenheimer & Co. [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,551 at 86,415 n.2; Jennings & Marsh, *supra* note 4, at 952-53; Fleischer, *An Initial Inquiry, supra* note 4, at 798.

The distinction between market information and inside information is important because a person with market information is likely to be an outsider and a person with access to inside corporate information is likely to be an insider. Insider/outsider status may be important in determining the obligation to disclose, because courts have required insiders and their tippees to disclose to the company stockholders on a fiduciary theory. *See* notes 20-61 *supra* and accompanying text. In certain situations, however, outsiders have also been charged with a duty to disclose. *See* notes 62-64 *supra* and accompanying text. The source of the outsider's duty cannot rest on a fiduciary theory since he has no fiduciary obligation to the stockholders of the issuer.

It should be noted that financial sophistication formed from generally available information is neither inside nor market information. It is presumed that some investors will be able to use such information in a way that enables them to profit more than other investors. There is no restriction on the financially sophisticated investor when he relies on information to which all other investors have access. *See Texas Gulf Sulphur,* 401 F.2d at 848; III Loss, *supra* note 3, at 1463; Jennings, *Insider Trading, supra* note 4, at 810; Schotland, *supra* note 83, at 1430; Note, *Investors Management: Institutional Investors as Tippees,* 119 U. Pa. L. Rev. 502, 508 (1971).

simply an extension of the older approach: it still focuses on the category of information and status of the defendant. In traditional applications of these concepts courts have proven willing to find defendants falling outside the categories[96] liable in order to effectuate a perceived underlying policy. However, the same concepts can be used to limit liability. If a defendant could persuade a court that he fell outside a predefined category, he might escape liability even if his trading violated equal access and exacerbated the ordinary investor's sense of market unfairness. Instead of continuing to expand the concepts to meet new factual circumstances therefore, this comment suggests that the better approach would be to abandon altogether the concepts of status/type of information as determinants of liability. The comment in this section proposes an alternative test for imposing liability under the equal access principle which *Chiarella* recognized. The proposed test would both give specificity to the vague equal access principle, and make a final break with the status inquiry perpetuated in the Second Circuit's "regular receipts" test. It would thus avoid the unwarranted limitations of that approach.

2. AN ALTERNATIVE TEST BASED ON MOTIVE

The proposed test is one of motive. Under this test anyone trading on material undisclosed information, no matter who and no matter what the source of the information, would be presumptively liable under rule 10b-5. The presumption could be rebutted by the trader's showing a legitimate business reason for his trading on non-public information: *i.e.*, a non-personal profit motive.[97]

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96. The expansion of liability in the category of persons is illustrated in the tracing of liability from the traditional corporate insider to controlling shareholders and tippees. *See* text accompanying notes 24-49 *supra*.

Examples of the category of information required to be disclosed include *In re* Honohan, discussed in note 33 *supra*, *In re* Blyth & Co., [1967-1969 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,647 (1969) (Treasury Department employee liable for wrongfully disclosing market information about interest rates of a forthcoming Treasury offering).

97. One could attack this test as unworkable on the ground that all trading involves personal profit. Even in trading for legitimate corporate objects, the corporation is seeking to increase its own profits. However, it makes sense in policy terms to distinguish these types of trading because of their differing potential impact on investor confidence. The added presence of a corporate purpose is likely to increase the perceived legitimacy of the trade, and is thus less likely to impair confidence in market fairness.

The proposal of a business purpose test conflicts with the Second Circuit's holding that the presence or absence of a business purpose was irrelevant in assessing Chiarella's liability. To support its view of the unimportance of business purpose in a 10b-5 inquiry the court cites Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1976). Yet as the Second Circuit itself concedes, the facts of *Santa Fe* were different since the issue was whether the *absence* of a business purpose would trigger 10b-5 liability even when the required disclosures were made.

As a means of defining the scope of liability, a motive test has important advantages over the older fiduciary notions and over application of the equal access principle through the *Chiarella* court's "regular receipt" test. It would encourage a case-by-case evaluation not possible under the older case law or even under *Chiarella.* Under traditional case law, liability was seemingly foreclosed in certain cases for defendants who were not traditional corporate insiders or their tippees,[98] without regard to the merits of a particular case. Even under *Chiarella,* trading by outsiders would not always be proscribed: if an outsider used nonpublic information to his advantage but did not regularly receive such information, he would apparently not be liable in a 10b-5 cause of action.

The proposed test's restriction of liability to cases involving a personal profit motive seems to make sense in terms of the Exchange Act's goals of restoring investor confidence and sustaining vigorous capital markets.[99] Restricting liability to cases involving trading for personal gain is consistent with the view that an investor is less likely to feel as acute a sense of unfairness where no other identifiable individual is profiting directly at his expense. Second, he may think that information accruing to such investors engaged in business activity is likely to strengthen the market overall and thus ultimately redound to his benefit.

The legitimate business activity that would permit a rebuttal of presumptive liability under the test is less likely to involve nonpublic information about the *issuer's* financial worth than is trading for personal profit.[100] Legitimate activity is more likely to be based on information that the defendant himself has generated, as in the case of a defendant's intent to make a tender offer. Trading on the basis of such information should not tend to impair investor confidence; in such cases the average investor is not likely to feel totally foreclosed since he has the same opportunity as the offeror to decide that the stock is undervalued and purchase it.[101]

Chiarella, 588 F.2d at 1368 n.15. Thus, *Santa Fe* does not resolve the question of whether the *presence* of a legitimate business purpose can protect conduct that would otherwise be prohibited by 10b-5.

98. *See* cases cited in note 63 *supra* where courts refused to hold outsiders liable for nondisclosure.

99. *See* notes 88-89 *supra.*

100. Although it might appear that in drawing attention to the type of information the comment is reelevating the importance of a discredited basis for imposing liability, in fact it is not doing so. It is merely suggesting that because legitimate business activity is not likely to involve the witholding of information whose nondisclosure will impair investor confidence, it should not be subjected to a *presumption* of liability.

101. The Second Circuit found the fact that the offeror does not receive but creates information to be a significant reason for exempting it from liability for nondisclosure. *Chiarella,* 588 F.2d at 1366. If one accepts the distinction between creating and receiving

The motive test focuses on the appropriate issue. Instead of looking to the status of the defendant or to the kind or source of information, it inquires instead whether there has been trading on nonpublic information which is sufficiently like cheating[102] to impair investor confidence. The test provides a means of screening out those instances where there should be no liability even though there is technically a violation of the equal access principles, by providing a defense for those having a legitimate business reason for their conduct. It thus encourages desirable economic activity.[103]

B. *Some Examples: The Motive Test Applied to Outsider Trading*

To guage the usefulness of the motive test as a means of identifying how far the scope of liability for nondisclosure should extend under 10b-5, several examples involving trading by outsiders with access to nonpublic information will be explored. In the *Chiarella* situation, for example, the mere fact that the information was market information rather than information about the financial worth of the company would not immunize Chiarella from liability.[104] Nei-

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information as an important one in defining liability, it could be argued that institutional investors, discussed in text accompanying notes 113-16 *infra,* to whom the offeror leaks information to induce the lender to finance the takeover, would be liable as receivers of information. However, the institutional investor should escape liability for nondisclosure because even in such cases the investor can decide on his own to buy the undervalued stock.

102. The term "cheating" is not used as one of moral opprobrium but is used to refer to trading that would strike the ordinary investor as unfair and reduce the likelihood of his participation.

103. A recent student note proposed an alternative test which would also help to preserve incentives for such activity. *See* Comment, *The Application of Rule* 10b-5 *to Market Insiders*, 92 HARV. L. REV. 1538, 1547 (1979) [hereinafter cited as Comment, *Market Insiders*]. Under the proposed test, those who regularly receive nonpublic information would be forbidden from using it except in connection with their market function. Because this test is narrower, it may help to provide additional incentives for economic activity; however, the inquiry still focuses on the status of the defendant through his position in the market and thus fails to address the importance of the underlying policy of equalizing access to information.

104. *Chiarella*, 588 F.2d at 1358. For a discussion of the concept of market information see text accompanying notes 93-96 *supra.* The SEC has signalled its view that the misuse of market information may amount to a violation of 10b-5. *See In re* Honohan, 13 S.E.C. 754 (1943) (broker-dealer who misappropriated nonpublic market information guilty of violating 10b-5).

The Commission has also applied 10b-5 to market information frauds in two other contexts. Recent consent decrees have been obtained in several instances where confidential market information concerning potential tender offers has been misappropriated. *See* SEC v. Primar Typographers, Inc., [1976-1977 Transfer Binder] FED. SEC. L. REP (CCH) ¶ 95,734 (S.D.N.Y.); SEC v. Ayoub, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,567 (S.D.N.Y. 1976); SEC v. Sorg Printing Co., [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,767 (S.D.N.Y. 1974). Executives of acquired companies with nonpublic market information of an impending tender offer have also been the subject of SEC enforcement actions under 10b-5. *See* SEC v. Stone, SEC Litigation Release No. 8527 (S.D.N.Y. 1978);

ther would his status as an outsider.[105] Because he traded on material nonpublic information, he would be liable unless he could show there was a legitimate business reason for his conduct. Since he converted information to his personal use,[106] he could not rebut the presumption of liability and would be liable for nondisclosure for exploiting uninformed investors.

Another trader who would be subject to the disclose-or-abstain rule because he could offer no financial justification for his conduct would be a financial journalist who trades on the basis of information he knows will be printed on the following day. This was the situation in *Zweig v. Hearst Corp.*,[107] where a journalist wrote a column that contained a highly favorable description of a company known as ASI on the basis of material misrepresentations which the company supplied. Before publishing the article he bought 5,000 shares at a discount below market price; after publication, the owners of a second company merged into ASI in return for stock that was temporarily inflated due to the misrepresentations in the article.[108] The owners who had merged brought a 10b-5 suit alleging damages suffered as a result of their reliance on the columnist's misrepresentations. The court found the columnist liable for dam-

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SEC v. Healy, SEC Litigation Release No. 6589 (S.D.N.Y. 1974); SEC v. Rosenberg, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 74,766 (S.D.N.Y. 1974).

The Second Circuit's adoption of the view reflected in the foregoing SEC enforcement proceedings—that the misuse of market information can furnish the basis for a fraud action—seems to make sense in policy terms. It should make no difference that the information a trader acquires by virtue of his strategic position differs from that acquired by the corporate insider. To protect the justifiable expectations of investors, disclosure would be required in each case. Yet until *Chiarella*, it was unclear whether an outsider who trades on advance knowledge of stock market events, but who has no information about the company's financial worth not publicly available, would be liable for nondisclosure. *See* cases cited in note 63 *supra* (exempting outsiders from liability for nondisclosure). *But see* text accompanying note 64 *supra*.

105. For a case where an outsider was held liable for nondisclosure, see text accompanying note 64 *supra*. The *Chiarella* court thought that the defendant's status was really irrelevant in a determination of liability under 10b-5. In responding to the status argument—that because Chiarella was not an insider he owed no fiduciary duty—the court said, "That appellant was not an insider . . . is true but irrelevant." *Chiarella*, 588 F.2d at 1364. The court based its rejection of the status rationale on its perception of the purposes of the antifraud provisions. The court took a broad view of those purposes when it held that those provisions were designed to insure "that all investors trading on impersonal exchanges have relatively equal access to material information." *Id.* at 1365.

106. *Id.* at 1367. The Second Circuit found that such conversion resulted in Chiarella's violation of his duties as an agent under § 395 of the *Restatement (Second) of Agency*. Moreover, the court concluded that this violation itself constituted a violation of 10b-5 since it was connected with and used to sell securities. *Id.* at 1368 n.14. This comment suggests that the trader's business purpose—rather than the presence or absence of an agent's duty to his principal—should form the basis for a liability inquiry. *See* note 97 *supra*.

107. [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,851 (9th Cir. 1979).

108. *Id.* ¶ 96,851 at 95,457-58.

ages on the ground that he had a duty to his readers either to refrain from trading, or to disclose the fact that he had purchased stock at a bargain on the expectation that he would write his column and sell on the rise.[109]

Although the *Zweig* court reached the correct result because to have allowed the trading would have impaired the confidence of future investors in the integrity of the market, it makes more sense to ground the duty on a straightforward application of the equal access principle through a motive test. Such an approach would obviate the need to unduly stretch the broad holding in *Affiliated Ute*—which is exemplified by the *Zweig* opinion—or to pin too much on specialized concepts such as a journalist's duty to his readers. Since the journalist traded solely for his own gain, he would not be able to rebut the presumption that the trading was proscribed.

To assess the sweep of the motive test, it is necessary to look not only at cases where it would result in a finding of liability, but also where it would protect trading on nonpublic information. The test would protect such trading where the trader could offer legitimate business reasons for his activities.

For example, under the proposed test a tender offeror who has an undisclosed intention to make a tender offer would not be subjected to liability for trading on that nonpublic information. Although the unannounced intention is material, and permitting the tender offeror to trade without disclosing gives him an advantage, the tender offeror would nonetheless be able to show that his primary goal in trading would not be to garner personal profits but to serve a more general corporate purpose of acquiring a target company which would be a useful addition to his own company. He would therefore be able to rebut the presumption of liability.

The tender offeror's exemption from liability for preannouncement trading under this test would have conflicted with the SEC's

109. The court found the violation of the readers' expectations that the journalist would remain objective to be an important factor in imposing liability. *Id.* ¶ 96,851 at 95,460.

In finding a duty of disclosure, the court conceded that most cases requiring disclosure that were cited by the parties were different because they dealt with corporate insiders trading in the corporation's stock. *Id.* ¶ 96,851 at 95,460. However, the court found that a number of cases were not so limited and extended the duty to nontraditional insiders. *Id.* ¶ 96,851 at 95,462.

The court admitted that it was difficult to find a duty in traditional common-law terms but concluded that liability was consistent with the letter and spirit of the securities laws. *Id.* ¶ 96,851 at 95,463. To reach that conclusion the court analogized the columnist to the transfer agents in *Affiliated Ute* and concluded that a similar duty existed in each case. The court also grounded its conclusion of a duty on the journalist's duty to his readers to remain objective. *Id.* ¶ 96,851 at 95,460-61.

proposed rule 14e-2(c).[110] Under that proposed rule a bidder who determined to make a tender offer but had not yet publicly announced his decision would be subject to liability for nondisclosure. Under the motive test a different result would obtain; the offeror would be liable only if he were acting to enhance personal gain.

In response to criticism of the proposed rule the SEC has withdrawn it.[111] As a result, the outcome under the suggested motive test does not conflict with the SEC's present tender offer rules, which permit the tender offeror to make preannouncement purchases and restrict him only in that he may not disclose or leak the information to anyone else whom he knows would similarly engage in preannouncement trading.

The withdrawal of the proposed rule imposing broad disclosure obligations on the bidder appears to be proper. The rule did not take sufficient account of the congressionally recognized value of tender offers in achieving honest and fair management.[112] Provided no similar rule is ultimately adopted, the motive test should yield results congruent with SEC tender-offer policy.

Another class of investors who would be able to rebut the presumption of liability under the motive test because of the presence of a legitimate business objective would be the institutional investors, known as warehousers, who assist the tender offeror in financing a takeover bid. In warehousing[113] the tender offeror gives a bank or other investor advance notice of his impending tender offer. On the basis of that information the investor purchases stock of the target, which then can serve as security for a loan to finance the tender offer.[114] This practice allows the offeror to obtain certain financing which might otherwise be unavailable.[115] Because the institutional investor does not use the information for personal gain, it would be able to escape liability under the proposed test.[116]

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110. 44 Fed. Reg. 9,954, 9,988 (1979).

111. Commentators pointed out that the proposed rule would discourage tender offers by preventing the acquisition of negotiated block stock purchases as a prelude to what is known as an "any and all" tender offer to all stockholders at the same price. Moreover, commentators argued that since pre-offer purchases might be construed as a violation of the rule, bidders would refrain from making any offers. [Current Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,373 at 82,598.

112. *Id.*

113. For a discussion of this practice, see SEC INSTITUTIONAL INVESTOR STUDY REPORT, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. 2773, 2828 (1971); Fleischer, *An Initial Inquiry*, *supra* note 4, at 814; Comment, *Market Insiders*, *supra* note 103, at 1546.

114. *See* Comment, *Market Insiders, supra* note 103, at 1546.

115. *See id.*

116. In contrast, the SEC's proposed new tender offer rules would restrict the ability of institutional investors to act as warehousers in financing a takeover bid in two ways. First, the rules would proscribe any trading by a person other than the bidder who was in possession

These proposed rules would operate to subject institutional investors to a disclose-or-abstain rule and would effectively prevent them from operating as interim financers for proposed takeovers. The preannouncement purchases are what provide investors with adequate security to make the loan on which the offer can proceed. To require them to disclose or abstain from trading would put them in the same position as all investors and effectively deprive them of the financial cushion on which to extend a loan. This comment suggests that because the proposed rules would interfere with the financing of tender offers and so with a major incentive for desirable economic activity they should not be adopted in their present form.

Although the courts and the Commission, by their continuous expansion of the scope of 10b-5, have reflected a belief in the importance of insuring equal access to investors, there are problems with a test based on equal access and in some of the alternative standards which have been proposed. The test based on the presence or absence of a motive to obtain personal profit goes to the heart of 10b-5, which is a concern that depriving investors of equal access to information can impair investor confidence and the capital markets. The test focuses attention on what should be the main concern of courts in determining whether there should be liability for nondisclosure of nonpublic information. It properly deemphasizes the importance of factors like status and type of information withheld since these factors are unrelated to the impact on investor confidence. Moreover, the test is a workable one which gives courts a way of ensuring that liability does not go too far. Finally, it gives the courts a device for preserving desirable economic activity while ensuring fairness in the securities markets.

Conclusion

This comment has explored the problem of liability for nondisclosure of material information under rule 10b-5. Although the courts and the Securities and Exchange Commission have confronted that issue in numerous contexts, they have largely failed to articulate clearly the principle explaining their continued expansion of the scope of liability. Initially they grounded liability on common-law concepts of fiduciary duty and status. When new situations arose which called for disclosure, they found a duty to disclose by simply expanding the reach of these concepts. In *United States v. Chiarella*

of information (material and nonpublic) relating to a tender by another person unless, prior to such trading, the person publicly announced the information and its source. Second, the rules would prohibit the offeror from divulging any material nonpublic information to any person whom it had reason to believe would use the information to purchase stock.

the Court of Appeals for the Second Circuit abandoned this circuitous approach and clearly articulated a unifying principle underlying the duty of affirmative disclosure: assuring all investors equal access to market information. This comment suggests that although the explicit recognition of that principle is new, there is implicit support for it in both the prior case law and legislative history.

This new recognition of equal access, however, provides only an incomplete solution to the problem of defining the scope of liability for nondisclosure because it is an inherently vague and open-ended concept. To effectuate the principle the Second Circuit proposed a test based on the regular receipt of market information. That test, however, retains the disadvantages of the pre-*Chiarella* case law: it focuses on the category of person and type of information and, as formulated it could operate to prohibit even desirable economic activity. This comment therefore suggests an alternative test to effectuate the equal access principle based on motive or business purpose, and urges its adoption.

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