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Trading on Market Information: Rule lOb-5 and Market Insiders-*United States v. Chiarella*

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to broadcast, coupled with the ability of listeners to turn off the program, would seem adequate to protect privacy rights of undesirous listeners. If the Court is to remain true, therefore, to that developing view of the first amendment as protecting not only speech deemed valuable as a matter of consensus, but also language which may appear iconoclastic and even offensive by virtue of its form, the balancing methodology of the Court, as paternalistically applied to the broadcasting medium in *Pacifica*, must be critically reappraised. Once the public interest standard governing the airwaves is seen as encompassing a constitutional concern for promoting the pursuit of individual identity as an essential means of fostering societal well-being, then the role of the Commission must be entirely different from that articulated in *Pacifica*. Rather than tailoring language to fit a procrustean bed of prevailing community acceptability, the FCC must commit itself to maintaining broadcasting as an open forum—a forum which, with appropriate prior warnings, will provide the widest possible range of diversified communications.

JACQUELINE SHAPIRO

Trading on Market Information: Rule 10b-5 and Market Insiders—*United States v. Chiarella*

In United States v. Chiarella, *the Court of Appeals for the Second Circuit held that anyone who regularly receives material nonpublic information is subject to the prohibitions of rule 10b-5. The author of this casenote discusses the expansion of liability created by this holding and analyzes the questions raised by the decision.*

Vincent Chiarella was an employee of Pandick Press, a printing house located in downtown Manhattan. Pandick Press specializes in printing financial documents such as annual reports, proxy statements and disclosure statements for tender offers and mergers. Between September 1975 and November 1976, Pandick Press printed documents for five separate takeover bids.[1] Chiarella, a "markup

1. Four of the transactions in question involved tender offers and one was a merger. The record did not disclose whether the takeovers were "hostile." Neither the parties nor the court attached any significance to these distinctions.

man" in the composing room at Pandick, was the first to receive incoming manuscripts. After selecting type fonts and page layouts, he passed the manuscripts along to be typeset.

In order to preserve confidentiality and to avoid any anticipatory rise in the market price of a target company's stock, the lawyers and investment bankers who prepared the manuscripts for printing coded the names of the offeror and the target company. Chiarella, however, was a knowledgeable stock trader, and by using other information contained in the documents, was able to identify the companies involved in each of the takeover bids. Disregarding signs posted throughout Pandick Press to the effect that the use of customer information for personal gain was illegal, Chiarella called his broker and purchased shares in the target companies. Naturally, when news of the tender offer hit Wall Street, the market price of the target company's stock rose sharply. Chiarella quickly sold out and realized a handsome profit. During the period in question, Chiarella netted over $30,000.00.

In 1977, the Securities and Exchange Commission began to investigate Chiarella's activities. In May of 1977, Chiarella entered into a consent decree whereby he agreed to make restitution to those who had sold him the target stock. The same day, his employment with Pandick Press was terminated. On January 4, 1978, Chiarella was indicted on seventeen counts of willful misuse of material nonpublic information in connection with the purchase or sale of securities. The indictment alleged that Chiarella's activities were in violation of section 10(b) of the Securities Exchange Act of 1934[2] and rule 10b-5,[3] promulgated thereunder.[4]

Chiarella moved to dismiss the indictment on the grounds that the SEC had not charged a crime under section 10(b) or rule 10b-5. Essentially, Chiarella argued that he had not been an insider of the target companies and owed no fiduciary duty to target shareholders. Thus, he was not among those required either to disclose material nonpublic information or to refrain from trading on that informa-

2. 15 U.S.C. § 78j(b) (1976).

3. 17 C.F.R. § 240.10b-5 (1979).

4. Specifically, Chiarella was indicted under § 32(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78ff(a) (1970) [hereinafter the 1934 Act]. Section 32(a) is the penal provision of the 1934 Act and essentially provides that a willful violation of any provision of the 1934 Act may result in a criminal conviction with a fine not exceeding $10,000, imprisonment not exceeding five years or both. 15 U.S.C. § 78ff(a). Chiarella was indicted on 17 counts because he had made 17 separate purchases of stock. On each occasion, he telephoned his broker and a confirmation slip was sent to him by mail. The mailings sufficed to invoke federal jurisdiction. United States v. Chiarella, 588 F.2d 1358, 1364 n.6 (2d Cir. 1978).

tion.[5] Judge Owens of the District Court for the Southern District of New York denied Chiarella's motion to dismiss. After a jury trial on the merits, Chiarella was found guilty on all seventeen counts. On appeal, the Court of Appeals for the Second Circuit held, *affirmed: Anyone* who regularly receives material nonpublic information is under an affirmative duty to disclose that information, or if the information cannot be disclosed, must abstain from trading on that information. *United States v. Chiarella*, 588 F.2d 1358 (2d Cir. 1978), *cert. granted*, 99 S. Ct. 2158 (1979).

The rule prohibiting trading on "inside information" had its genesis in section 10(b) of the Securities Exchange Act of 1934.[6] The section was enacted primarily as an aid to federal regulators policing fraud in the securities markets.[7] In 1936, the Securities Exchange Act was amended by adding a provision prohibiting the use of manipulative, deceptive or fraudulent devices and contrivances by brokers and dealers.[8] In 1938, Congress enacted the Maloney Act and,

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5. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

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

> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1976).

A somewhat broader version of this provision was proposed during the second session of Congress in 1934. *See* S. 2693 and H.R. 7852, 73d Cong., 2d Sess. (1934). Several witnesses testified at hearings before the Senate and House committees that this version was overly broad, *Hearings on S. 2693 Before the Senate Committee on Banking and Currency*, 73d Cong., 2d Sess. 6634 (1934); *Hearings on H.R. 7852 Before the House Committee on Int. and Foreign Commerce*, 73d Cong., 2d Sess. 115, 258, 305 (1934). Accordingly, it was rejected in favor of the present statutory language.

7. Prior to enactment of the 1934 Act, regulators had to rely upon § 17 of the Securities Act of 1933 [hereinafter referred to as the 1933 Act]. For the specific language of that provision, see 15 U.S.C. § 77q (1976).

Section 17 is a general antifraud provision which offers significant procedural advantages over common law fraud. It is designed to apply only to the securities markets and enables the Securities and Exchange Commission (SEC) to obtain injunctive relief before the fraud occurs (or before the fraud has been extensively perpetrated). In addition, § 17 applies to material misrepresentations and half-truths rather than fraud per se. The language of § 17 covers only offers to sell or actual sales of securities, and the SEC has sought to apply it only against fraudulent sellers. In contrast, § 10(b) applies to both buyers and sellers of securities. 3 L. Loss, Securities Regulation 1423-25 (2d ed. 1961).

8. This provision is currently found in § 15(c)(1) of the 1934 Act. 15 U.S.C. § 78o(c)(1) (1976). The provision is self-implementing in that the Commission need not adopt rules and regulations to prohibit such fraudulent schemes. It is limited, however, to transactions by

as a part of that bill, added provisions which prohibited brokers and dealers from using fictitious quotations or fraudulent, deceptive or manipulative acts or practices. That Act also granted the Commission rulemaking power to establish regulations that would prevent such quotations, acts and practices.[9]

Even after the 1936 and 1938 amendments, however, nothing in either the 1933 Act or the 1934 Act or the rules and regulations promulgated thereunder prohibited fraudulent acts in connection with the *purchase* of securities by anyone other than an over-the-counter broker or dealer. An issuer, director, officer or controlling shareholder could utilize fraudulent practices in the purchase of securities and remain outside of the proscriptions of the federal securities laws.[10] In other words, nothing prohibited an "insider" from purchasing shares based upon material nonpublic information.

In 1941, the Commission suggested extending the scope of section 17(a) of the 1933 Act to include both the purchase and the sale of securities.[11] This proposal was eventually abandoned; but in 1942, Milton V. Freeman, then an Assistant Solicitor at the SEC regional office in Philadelphia, drafted a rule to close this loophole in the antifraud provisions of the securities laws.[12] He combined the "in

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brokers or dealers. Further, it is limited to over-the-counter transactions. Unlike § 17, § 15(c)(1) is not limited to offers to sell or actual sales, and in this respect it is similar to section 10(b). 3 L. Loss, *supra* note 7, at 1425.

9. The provisions are the present §§ 15(c)(2) & 15(c)(3) of the 1934 Act. 15 U.S.C. § 78*o*(c)(2),(3) (1976).

10. Naturally, the purchaser could be subject to a common law suit for fraud, but the remedy for fraud is generally viewed as inadequate since the seller bears the heavy burden of proving the traditional elements under state law. A purchaser would also be subject to federal criminal prosecution for mail fraud, or to the entry of a mail fraud order. These remedies are likewise considered inadequate. *See* 3 L. Loss, *supra* note 7, at 1423, 1426, 1431-33 (2d ed. 1961); 6 *id.* at 3534-35 (1969).

11. IBA et al., *Report on the Conference with the SEC and Its Staff on Proposals for Amending the Securities Act of 1933 and the Securities Exchange Act of 1934* 167 (1941), *cited in* 3 L. Loss, *supra* note 7, at 1426 n.17 (2d ed. 1961).

12. "The new rule [10b-5] closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from *buying* securities if they engage in fraud in their purchase." SEC Securities Exchange Act Release No. 3230 (May 21, 1942) (emphasis added). During a conference on codification of the securities laws, sponsored by the American Bar Association's Section of Corporation, Banking and Business Law, Mr. Freeman explained the origins of rule 10b-5 as follows:

> It was one day in the year 1943, I believe. I was sitting in my office in the S.E.C. building in Philadelphia and I received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, "I have just been on the telephone with Paul Rowen," who was then the S.E.C. Regional Administrator in Boston, "and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his shareholders at $4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and

connection with the purchase or sale" language of section 10(b) of the 1934 Act with the general language of section 17(a) of the 1933 Act. The result became the present SEC rule 10b-5.[13]

Since its inception, rule 10b-5 has been applied to a wide spectrum of fraudulent, deceptive and manipulative practices. In 1961, both a brokerage firm and a broker were disciplined under rule 10b-5 for purchasing securities based upon information which had not been disclosed to the investing public.[14] In *Cady, Roberts*,[15] an SEC proceeding, Cady, Roberts & Co., a brokerage firm, employed two brokers, Gintel and Cowdin. Cowdin was also on the board of directors of Curtis-Wright Corporation, which had recently unveiled a new type of internal combustion engine. The market price of Curtis-Wright stock had been rising for several days and had reached a new high for the year just prior to the transaction in question. On the morning of November 25, 1959, the board of directors of Curtis-Wright met to declare the final dividend of the year. The dividend

will be $2.00 a share for this coming year. Is there anything we can do about it?" So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where "in connection with the purchase or sale" should be, and we decided it should be at the end.

We called the Commission and we got on the calendar, and I don't remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, "Well," he said, "we are against fraud, aren't we?" That is how it happened.

Conference on Codification of the Federal Securities Law, 22 BUS. LAW. 793, 922 (1967).

13. Securities and Exchange Commission rule 10b-5, 17 C.F.R. § 240.10b-5 (1979). Rule 10b-5 reads as follows:

Employment of manipulative and deceptive devices

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

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

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

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

Rule 10b-5 has been upheld as being validly promulgated, Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 786 (2d Cir. 1951) (dictum); United States v. Shindler, 173 F. Supp. 393, 394-95 (S.D.N.Y. 1959), and has withstood constitutional challenges on the grounds of vagueness and improper delegation of authority. Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del.), *reaff'd on later motions*, 100 F. Supp. 461 (D. Del. 1951), *modified on other grounds*, 235 F.2d 369 (3d Cir. 1956).

14. *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

15. *Id.*

declared was less than any declared in the three previous quarters. After the declaration, the information was to be transmitted by telegram to the New York Stock Exchange. Due to a short delay, the information did not reach the exchange until shortly after noon. Furthermore, no news appeared on the Dow Jones ticker until 11:48 a.m. In the meantime, a recess of the directors meeting was called, and Cowdin telephoned Cady, Roberts & Co. to relay the dividend information. Upon receiving the information, Gintel executed several transactions in the stock.

After news of the dividend reduction hit "the Street," trading in Curtis-Wright had to be suspended due to the large number of sell orders pouring onto the floor of the exchange. Trading resumed later in the afternoon, but the price of the stock continued to fall dramatically. Because of the transactions Gintel had executed based upon the tip he received from Cowdin, the SEC instituted proceedings against both Cady, Roberts & Co. and Gintel.

The Commission ruled that both the broker and the firm had willfully violated section 17(a) of the Securities Act of 1933, section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5. Commissioner Cary discussed the traditional obligation of corporate insiders (*e.g.*, officers, directors and controlling shareholders) to disclose material nonpublic information or to abstain from trading on that information. The Commissioner then stated:

> These three groups [officers, directors and controlling shareholders], however, do not exhaust the classes of persons upon whom there is such an obligation. Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications.[16]

This language signaled the first step toward the result in *Chiarella*, which held that a "market insider" may be liable for trading on material nonpublic information regularly received in the course of

16. *Id.* at 912 (dictum) (footnotes omitted). For analyses of the *Cady, Roberts* decision, see Daum & Phillips, *The Implications of Cady, Roberts*, 17 Bus. Law. 939 (1962); *Insider Liability Under Securities Exchange Act Rule 10b-5*, 30 U. Chi. L. Rev. 121 (1962); Comment, 71 Yale L.J. 736 (1962).

employment, even though that employment is not with the corporation whose securities are traded.

In order to apply the *Cady, Roberts* analysis to the situation in *Chiarella*, it is first necessary to determine whether the first element was present; that is, whether there was a relationship which provided Chiarella access to corporate information. Chiarella certainly had such access since the raw material Pandick Press received was intended for use only upon disclosure of the tender offer.[17] The information was generated for a corporate purpose, compliance with the disclosure requirements of the Williams Act.[18] When Chiarella used this information for his personal benefit, he satisfied the access element of the *Cady, Roberts* test.

The second element of the *Cady, Roberts* analysis is the inherent unfairness involved when a person takes advantage of inside information while dealing with an uninformed trader. In *Chiarella*, this unfairness not only existed but also was particularly acute since Chiarella obtained the information illicitly.[19] Therefore, this author contends that it was unnecessary for the court in *Chiarella* to create a new, broader definition of a "market insider" under rule 10b-5. By simply applying the obiter dictum of *Cady, Roberts*, the same result may have been achieved without creating unnecessary uncertainty by redefining the term "insider."[20]

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17. *See* 588 F.2d at 1363.

18. 15 U.S.C. §§ 78m(d), 78n(d) (1970).

19. The element of unfairness has been challenged by Henry Manne, an eminent writer in the field. H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966); Manne, *In Defense of Insider Trading*, 44 HARV. BUS. REV. 113 (Nov.-Dec. 1966). Essentially, Professor Manne attacks the unfairness notion on two grounds. First, he contends that insider trading would improve stock market "continuity." In other words, as insiders traded on inside information the price of the stock would tend to rise slowly rather than rising sharply as it would upon public disclosure of the information. H. MANNE, *supra*, at 99-103. This would be true regardless of whether the person acting on the inside information were an insider. In this respect, the actions of Chiarella are consistent with the Manne thesis since Chiarella's activities caused the market price of target company stock to rise. *See* 588 F.2d at 1368.

Professor Manne's second contention is that unrestricted insider trading is necessary since it is the only appropriate form of compensation for entrepreneurial activities. H. MANNE, *supra*, at 132-33, 138-41. The facts of *Chiarella* make Professor Manne's second point irrelevant since the defendant was not performing any entrepreneurial function. *A priori*, he should not have been rewarded for his activities, especially since he obtained the information in an improper fashion. Therefore, even under the Manne thesis, the insider training prohibition should have been imposed under the circumstances in *Chiarella*.

20. Although the *Cady, Roberts* analysis of the policies behind implying a duty of disclosure has served as a model for subsequent decisions in various courts, Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 805 (1973), citation to *Cady, Roberts* was conspicuously absent from the *Chiarella* opinion. There may be several reasons why the court in *Chiarella* did not follow the analysis of *Cady, Roberts*. First, *Cady, Roberts* was an SEC disciplinary proceeding and

The landmark case of *SEC v. Texas Gulf Sulphur Co.*[21] *(TGS)* reaffirmed the rationale of *Cady, Roberts. TGS* was an action for injunctive relief and rescission of certain transactions which allegedly violated both section 10(b) of the 1934 Act and rule 10b-5. Certain individuals associated with Texas Gulf Sulphur Co. had purchased TGS stock or calls for their own behalf. The purchases were allegedly made on the basis of material nonpublic information.[22] The Court of Appeals for the Second Circuit, sitting en banc, held that anyone in possession of material inside information must either disclose it to the investing public or, if prevented from disclosing the information in order to protect a corporate confidence, must abstain from trading in or recommending the securities concerned while the information remains undisclosed. In so holding, the court agreed that the policy behind rule 10b-5 was correctly stated in *Cady, Roberts.*[23] The court also reasoned that: "[w]hether predicated on traditional fiduciary concepts, . . . or on the 'special facts' doctrine, . . . the Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information . . . ."[24]

Naturally, one questions why the court in *Chiarella* did not simply affirm the lower court's decision based upon the *TGS* opinion. In *Chiarella*, the majority first analyzed the situation according to the principles established in *TGS.* But the defendant, Chiarella, argued that he was not an insider of the corporations whose securities he purchased, that he was not under a fiduciary duty to target company shareholders, and that hence, he was not within the ambit of rule 10b-5. At this point, the *Chiarella* court, recognizing that the defendant was not a traditional corporate insider, departed from prior precedent and created a new category of "market insider," *i.e.*,

thus provided only persuasive authority for the court of appeals. Second, *Chiarella* involved a criminal prosecution under the 1934 Act (the majority in *Chiarella* seemed to regard this distinction as immaterial). 588 F.2d at 1368 n.16. Third, Chief Judge Kaufman, who wrote the opinion in *Chiarella*, may have wanted to broaden the definition of insider under rule 10b-5. Kaufman first indicated his desire to expand the insider trading prohibition in SEC v. Great American Indus., Inc., 407 F.2d 453, 463 (2d Cir. 1968) (en banc) (Kaufman, J., concurring), *cert. denied*, 395 U.S. 920 (1969). *See* text accompanying notes 29-33 *infra.*

21. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 404 U.S. 1005 (1971).

22. Texas Gulf Sulphur Co. was engaged in the exploration of areas in eastern Canada for mineral deposits. An extraordinarily ore-rich area was discovered. Before this information was disclosed to the public, the securities transactions in question were consummated. 401 F.2d at 843-47.

23. *Id.* at 848.

24. *Id.* (citations omitted).

one who has regular access to market information. This departure was unnecessary. As the court in *TGS* noted, the rule prohibiting trading on inside information need not be predicated solely on traditional notions of fiduciary duty.[25] The policy underlying rule 10b-5, as the court in *TGS* recognized, stems from the justifiable expectation of equal access to information,[26] and that policy could have served as the basis for the court's decision in *Chiarella*. While the court did mention the policy, it added that the principle underlying *TGS* was broad and also encompassed the policy of "protect[ing] the integrity of the marketplace in which securities are traded."[27]

This author submits that the court in *Chiarella* should not have embarked upon an exercise of judicial legislation by going beyond that reasoning which was necessary to decide the case. The policy and analysis underlying *Cady, Roberts* and *Texas Gulf Sulphur* certainly provided sufficient legal precedent to achieve the *Chiarella* result. By creating the new category of market insider,[28]

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25. Arguably, the necessary implication of this statement, as per the court's opinion in *TGS*, is that the rule prohibiting trading on inside information must be based on the "special facts" doctrine of Strong v. Repide, 213 U.S. 419 (1909); *see* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968). In *Strong*, a controlling shareholder was found guilty of fraud in purchasing the holdings of a minority shareholder. The controlling shareholder, also a director and general manager of the corporation, failed to disclose to the agent of the minority shareholder that the United States government was planning to purchase lands owned by the corporation. The Court held that the controlling shareholder was under a duty to disclose this fact prior to the purchase of the minority shareholder's stock.

It would have been difficult, at best, for the court in *Chiarella* to extend the rule of *Strong* to the situation under consideration. First, the Court in *Strong* intimated that there would have been no duty to disclose had the controlling shareholder not been a director of the corporation. 213 U.S. at 431. Second, *Strong* was decided under common law precepts, while *Chiarella* arose under the federal securities laws. Therefore, the *Strong* doctrine left the majority in *Chiarella* no concrete rule of law (as opposed to policy considerations) under which it could impose the duty to disclose upon Chiarella.

26. *Chiarella* could be read in this somewhat narrow sense, notwithstanding the language regarding the new category of market insider. This reading, however, is problematic. First, no case has ever held that there must be parity of information between parties to a securities transaction. Fleischer, Mundheim & Murphy, *supra* note 20, at 806. Second, a rule requiring equality of information would be nearly impossible to enforce. By its very nature, the dispersion of information is unequal due to the logistics of communications systems and their inherent inability to relay information to investors spontaneously. Finally, the parameters of such a rule would be difficult to define. If access to information must be "relatively" equal, the focus of analysis turns to what is relative equality or inequality. This necessarily involves subjective decisionmaking, which is anathemic to business needs for a well-defined rule by which business persons may govern themselves.

27. 588 F.2d at 1365.

28. In a short paragraph, the court in *Chiarella* argued that the duty to disclose arising from regular access to market information is not a stranger to the world of rule 10b-5. 588 F.2d at 1366. Before exploring this argument, one must distinguish inside information from market information. Traditionally, inside information has been defined as information which directly relates to the company's assets or earning potential. For example, the discovery of a

the court undoubtedly expanded the duty to disclose beyond that which was established in *TGS*.

Perhaps the reason for the court's plunge into new frontiers can be gleaned from *SEC v. Great American Industries, Inc.*[29] In *Great American*, the SEC brought an action for injunctive relief against Great American Industries and certain individuals, alleging that Great American had issued press releases and filed an 8-K report that contained omissions or misstatements of material facts.

Great American, in anticipation of the purchase of certain mining properties in California, Nevada and Arizona, had issued press releases and filed an 8-K report stating that the property was ready to mine although, in fact, Great American was in the process of

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rich ore field, an increase or decrease in dividends and the development of a new type of internal combustion engine are all types of inside information. Each directly relates to the assets or earning potential of the company.

In contrast, market information is defined as information which affects the market value of the company's securities, but which is not directly related to the company's assets or earning potential. For example, an impending tender offer at a price substantially above the market, an imminent recommendation by a large brokerage firm's analyst to buy or sell a particular security, or the intention of a large institutional investor to move a large block of securities would affect the market price of the company's stock but would not directly relate to the assets or earning potential of the company. The inside information involved in *Cady, Roberts* and *Texas Gulf Sulphur* falls into the first category, whereas the information in *Chiarella* falls into the second category.

In order to buttress its argument that the duty to disclose based upon regular access to market information is not new to rule 10b-5, the court in *Chiarella* cited Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972). In *Affiliated Ute Citizens*, a bank was acting as a transfer agent for shares of Ute Distribution Corporation (UDC), a corporation created by the United States government to hold assets for a group of Ute Indians. Two employees of the bank actively encouraged the creation of a market in UDC stock by soliciting and accepting orders for UDC stock from non-Indians. Two markets developed, a primary market of Indians selling to non-Indians through the bank and a secondary market consisting of non-Indians trading among themselves. The Court held that the actions of the two employees constituted a device or scheme which defrauded the Indian sellers under rule 10b-5.

The majority in *Chiarella* argued that even prior to *Chiarella*, this holding created a duty to disclose market information whether or not the person trading on that information was an insider in the traditional sense. The dissent in *Chiarella* argued persuasively that the duty to disclose in *Affiliated Ute Citizens* was created by the actions of the two employees in devising a plan to induce the Indians to sell their stock. Therefore, according to the dissent, a noninsider had no duty to disclose market information prior to the court's decision in *Chiarella*.

The Court in *Affiliated Ute Citizens* stated in dictum that if the bank had merely acted as a transfer agent there would have been no affirmative duty to disclose. 406 U.S. at 151-52. Only the affirmative acts of encouraging a market for UDC shares created the duty to disclose. Therefore, by imposing the duty to disclose on noninsiders with regular access to market information, the majority opinion in *Chiarella* certainly seems to occupy new ground, notwithstanding the majority's arguments to the contrary. Other than *Affiliated Ute Citizens*, the majority cited no case in which liability under rule 10b-5 was imposed on anyone other than an insider, a tippee or one in a "special relationship" with the issuer.

29. 407 F.2d 453 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 920 (1969).

doing a feasibility study on the property. The transaction was arranged through finders who were to receive nearly two-thirds of the purchase price in stock of Great American. The Court of Appeals for the Second Circuit, sitting en banc, held that the press releases and the 8-K report warranted the issuance of an injunction against the company. The court also held that the issuance of an injunction against the sellers and finders was warranted since their actions constituted common law fraud. The court was unwilling, however, under the insider trading theory, to impose any duty of full disclosure upon the sellers and finders, since they were neither insiders nor in a special relationship with the company.

> It must be conceded that imposing on sellers of property or finders a duty of full disclosure to a buyer issuing securities in exchange, with a consequent duty on the part of the latter to publicize material facts so disclosed, would increase the protection afforded investors and traders by the securities laws. On the other hand, to read Rule 10b-5 as placing an affirmative duty of disclosure on persons who in contrast to "insiders" or broker-dealers did not occupy a special relationship to a seller or buyer of securities, would be occupying new ground and would require most careful consideration.[30]

Three judges concurred in the opinion of the court in *Great American*, intimating that they would be willing to occupy this "new ground." Judge Kaufman, then a circuit judge, seemed to be the most willing of the three to extend rule 10b-5 to noninsiders.[31]

> Inasmuch as these cases are of great importance to the financial and business community, I believe it appropriate to add this caveat: Those who buy or sell securities may no longer assume that the unmended fences of common law fraud will remain the outer limits of liability under Rule 10b-5 . . . . [A]ny claim that material facts were withheld in a transaction in connection with the sale or purchase of securities must be scrutinized with care, whether or not there would have been liability at common law for such a deed.[32]

Precisely what Judge Kaufman would have based the duty to

30. 407 F.2d at 460. Although *Great American Industries* was decided prior to the Supreme Court's decision in *Affiliated Ute Citizens*, this passage supports the proposition that the court in *Chiarella* expanded the definition of insider under rule 10b-5 beyond the traditional categories of those who have a fiduciary relationship or those who stand in a special relationship with the company. *See also* ALI FEDERAL SECURITIES CODE § 1603, Comment (3)(d)(Mar. 1978 Proposed Official Draft) [hereinafter cited as FED. SEC. CODE].

31. Fleischer, Mundheim & Murphy, *supra* note 20, at 806.

32. SEC v. Great American Indus., Inc., 407 F.2d at 462-63 (Kaufman, J., concurring).

disclose upon is speculative. The above language comes close to implying that any securities transaction where one party uses undisclosed material information is inherently unfair. Judge Kaufman may have recognized that *Great American* was not the proper case for expanding the prohibition on using nonpublic information under rule 10b-5. Were the expansion based simply upon a principle of unfairness, the rule would take on a subjective connotation which would render it unworkable.[33] Hence, Judge Kaufman may have been waiting for a situation, similar to that of *Chiarella*, in which a more objective rule could be framed which would still expand the duty of disclosure under rule 10b-5 to cover noninsiders.

Under the new test of *Chiarella*, a person who is not a traditional insider may be subject to rule 10b-5 liability if he or she has "regular access to market information."[34] This test appears more workable than one based purely on unfairness. There are, however, certain problems with this test, the first of which stems from the court's discussion of the Williams Act. Chiarella argued that since he had purchased less than five percent of each target company's stock, he should be treated as a would-be tender offeror, who could purchase up to five percent without incurring any duty to disclose.[35] The court rejected this argument on two grounds. First, a potential tender offeror "does not regularly receive nonpublic information regarding any stock but its own . . . it does not receive information but creates it."[36] Second, a potential tender offeror is taking a substantial economic risk on the profitability of the takeover.[37]

Clearly, the court does not intend to imply that the result in *Chiarella* would have been different had the defendant received information concerning only one company. Thus, the court's distinction between Chiarella and a would-be tender offeror must rest on the fact that Chiarella took no economic risk, whereas a potential tender offeror takes a significant risk. But this distinction is problematic. Must a market insider incur no economic risk before a duty to disclose arises? If the duty to disclose arises only when a market insider incurs no economic risk, then what would happen in

33. *See* note 26 *supra*. " 'Fraud' still requires something more than 'unfairness.' " FED. SEC. CODE § 1603, Comment (3)(b).

34. 588 F.2d at 1365-66.

35. 588 F.2d at 1366. Chiarella's contention regarding a potential tender offeror's duty to disclose is entirely correct. Under the Williams Act, 15 U.S.C. §§ 78m(d), 78n(d) (1976), a potential offeror may purchase up to five percent of a target company's stock without incurring a duty to disclose its intention of making a subsequent tender offer at a price substantially above the current market price.

36. 588 F.2d at 1366.

37. *Id.* at 1366-67.

a situation in which a person received advance information that a large brokerage firm was about to publish a favorable report on a company along with a "buy" recommendation? Certainly a purchaser of that company's stock would incur some economic risk, albeit minor, since the recommendation would not in every instance cause the market price of the stock to go up. Should the holding of *Chiarella* therefore be limited to trading on advance market information when the person so trading incurs no *substantial* economic risk? How much economic risk must a trader incur before he is relieved of the duty to disclose market information?

These are difficult questions which will have to be resolved by future decisions. At this point, based on the majority's analysis in *Chiarella*, all that may be suggested is that the economic risk undertaken by a market insider must be less than the risk undertaken by any other trader of the security before an affirmative duty to disclose arises. But as the dissent in *Chiarella* pointed out: "We have been cited no case holding that the degree of risk assumed by a trader in possession of nonpublic information is determinative of the trader's liability for nondisclosure or renders his conduct fraudulent."[38] Therefore, it is unclear whether economic risk is a factor in determining when a duty to disclose arises.

The majority in *Chiarella* also buttressed its new definition of market insider by reference to The American Law Institute's Federal Securities Code, which codifies rule 10b-5 (in section 1602) and the prohibition on insider trading (in section 1603).[39] The comments

38. *Id.* at 1375.

39. SEC rule 10b-5 has been codified as follows:

> Sec. 1602 [**Purchases, sales, proxy solicitations, tender offers, and investment advice.**]. (a)
> [**General.**] It is unlawful for any person to engage in a fraudulent act or to make a misrepresentation in connection with (1) a sale or purchase of a security, an offer to sell or buy a security, or an inducement not to buy or sell a security, (2) a proxy solicitation or other circulation of security holders in respect of a security of a registrant, (3) a tender offer or a recommendation to security holders in favor of or opposition to a tender offer, or (4) activity or proposed activity as an investment adviser.

FED. SEC. CODE § 1602. Note, however, that the ALI has not attempted a complete codification of rule 10b-5. *See id.* § 1603, Comment (3)(d).

The traditional prohibition on insider trading has been codified as follows:

> Sec. 1603. [**Insiders' duty to disclose when trading.**] (a) [**General.**] It is unlawful for an insider to sell or buy a security of the issuer, if he knows a fact of special significance with respect to the issuer or the security that is not generally available, unless (1) the insider reasonably believes that the fact is generally available or (2), if the other party to the transaction (or his agent) is identified, (A) the insider reasonably believes that that person knows it, or (B) that person in fact knows it from the insider or otherwise.

to section 1603 make it clear that that section is designed to apply only to insiders, tippees and those having a special relationship with the issuer.[40] As the court in *Chiarella* explicitly recognized, the defendant did not fall within the scope of section 1603.[41] The court stated that "quasi-insiders" or market insiders would fall within the general proscriptions of section 1602 and that, "[i]n any event, we believe Chiarella's conduct was sufficiently egregious to fit the most restrictive definition of a quasi-insider who would be barred from trading by the general provisions of section 1602."[42]

This analysis, however, fails to apply the Federal Securities Code properly. In Comment (3)(d) to section 1603, the Code states that if a sufficiently egregious case of trading, while silent, *cannot* be rationalized on an "insider" analysis, the court may fall back on the relatively more general section 1602(a)(1).[43] The court in

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(b) ["**Insider.**"] "Insider" means (1) the issuer, (2) a director or officer of, or a person controlling, controlled by, or under common control with, the issuer, (3) a person whose relationship or former relationship to the issuer gives or gave him access to a fact of special significance about the issuer or the security that is not generally available, or (4) a person who learns such a fact from a person specified in section 1603(b) (including a person specified in section 1603(b)(4)) with knowledge that the person from whom he learns the fact is such a person, unless the Commission or a court finds that it would be inequitable, on consideration of the circumstances and purposes of this Code (including the deterrent effect of liability), to treat the person specified in section 1603(b)(4) as if he were specified in section 1603(b)(1),(2), or (3).

(c) [**Secondary insiders**]. Section 1603 applies to an insider specified in section 1603(b)(3) only to the extent that he knows a fact of special significance by virtue of his occupying that status.

FED. SEC. CODE § 1603.

40. *Id.* § 1603, Comment (2)(e)-(j).

41. 588 F.2d at 1365-66.

42. *Id.* at 1366.

43. With great respect to the three concurring judges in *SEC v. Great American Industries, Inc.*, 407 F. 2d 453 (2d Cir. *en banc* 1968), *cert. denied*, 395 U.S. 920, it is hard to find justification today for imposing a fiduciary's duty of affirmative disclosure on an outsider who is not a "tippee." It would be convenient to have a new category of "quasi-insider" that would cover people like judges' clerks who trade on information in unpublished opinions, Federal Reserve Bank employees who trade with knowledge of an imminent change in the margin rate [cf. *United States v. Peltz*, 433 F. 2d 48 (2d Cir. 1970), *cert. denied*, 401 U.S. 955; *Blyth & Co. Inc.*, Sec. Ex. Act. Rel. 8499 (1969); cf. also *United States v. Keane*, 522 F. 2d 534, 544-51 (7th Cir. 1975), *cert. denied*, 424 U.S. 976], and perhaps persons who are about to give profitable supply contracts to corporations with which they are not otherwise connected, while excluding persons who have merely decided to "go into the market in a big way." But all this does not lend itself to definition. It is difficult in the abstract to opine even on illustrative cases. Where, for example, would one place the outsider who is about to make a tender offer — or his depository bank?

The proposed answer to this conundrum lies in the juxtraposition of §1603

Chiarella did not follow this suggested approach, however, but analyzed the case on the basis of an insider theory, *i.e.*, that the defendant was inside the market and therefore prohibited from trading on information he received. This would be the proper analysis under section 1603 of the Code, but the court explicitly recognized that the case was not governed by section 1603.

The court then stated the bald proposition that this case would fall under the general provisions of section 1602. Although the court could have enumerated the factors which brought the case within section 1602, it chose not to do so. As the dissent pointed out:

> The majority sees in this new category [market insider] a strong resemblance to the concept of the "quasi-insider" suggested in the comments accompanying the American Law Institute's *Federal Securities Code* . . . . However, the proposed code quite clearly imposes an affirmative duty of disclosure *only* on insiders (explicitly defined in terms of their relationship with or access to the *issuer*) and tippees of insiders. The Reporter's comments indicate that the difficulties that would be posed by extending this duty to a wider range of traders were deemed to outweigh the "convenience" of such an extension. Thus, the drafters of the proposed Code respectfully rejected the position taken by the three concurring judges in *SEC v. Great American Industries, Inc.*, who expressed a willingness to catch non-insiders in the § 10(b) disclosure net. The ALI's proposed code, like prior law, explicitly recognizes that some cases of nondisclosure of material information by non-insiders, no matter how egregious, do not involve fraud and hence do not fall within the scope of § 10(b), the majority's statement to the contrary notwithstanding.[44]

Under the proper analysis, the court would have found Chiarella an insider under section 1603(b)(3) of the Code. Since Chiarella's relationship with the offeror companies, via his employment at Pandick Press, afforded him access to facts of special signifi-

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> with the more general §1602, which is as broad as Rule 10b-5 is today. The *relatively* more specific §1603 as applied to "insiders" will be used when possible. For example, some of these "quasi-insider" cases may fall under §1603(b)(3). But, to the extent that a sufficiently egregious case of trading while silent *cannot* be rationalized on an "insider" analysis, a plaintiff may fall back on §1602(a)(1). It must be immediately added that not *every* case of an outsider's trading without disclosure of a material fact is a "fraudulent act." Section 1603 reflects no universally applicable theory of "market egalitarianism." All that can be said here again — and this is consistent with the basic approach of not attempting a complete codification of Rule 10b-5 — is that, within the newly provided framework, this area must be left to further judicial development.

FED. SEC. CODE § 1603, Comment (3)(d).

44. 588 F.2d at 1374 (footnote omitted) (citations omitted).

cance, he would have been subject to the duty to disclose under section 1603. This analysis also would have been in accord with the Reporter's comments.[45] Therefore, one can only speculate as to whether the court was simply wrong in its analysis or whether the court intended to analyze the situation in a manner which would expand the definition of insider to include a market insider.[46]

In conclusion, this author suggests that the court in *Chiarella* may have been motivated by a "gut" feeling of unfairness regarding the defendant's activities. No one would argue with the proposition that the conduct of Chiarella was unfair to the sellers of target company stock. For federal securities law purposes, however, the issue is not whether the defendant's conduct was unfair, but whether that conduct violated any substantive provision of law. The court did not have to expand the definition of insider to include a market insider; reliance on the *Cady, Roberts* analysis, reaffirmed by *Texas Gulf Sulphur*, would have sufficed. Furthermore, the court could have applied section 1603 of the Federal Securities Code, rather than section 1602, to reach its result. As it stands, the court's decision in *Chiarella* expands the definition of insider far beyond the traditional categories. Perhaps the Supreme Court, in its apparent willingness to narrow the doctrine of fraud under rule 10b-5,[47] will, in its disposition of *Chiarella*, help contain the potential liability which may result from the decision of the Court of Appeals for the Second Circuit.[48]

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45. "For example, some of the 'quasi-insider' cases may fall under §1603(b)(3)." FED. SEC. CODE § 1603, Comment (3)(d).

46. *But see* notes 29-32 and accompanying text *supra*.

47. *See, e.g.*, Sante Fe Indus., Inc. v. Green, 430 U.S. 462 (1977); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438 (1976); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

48. Petition for certiorari was granted in Chiarella v. United States, 99 S. Ct. 2158 (1979).