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COMMENTS

DUE PROCESS AND CRIMINAL PENALTIES UNDER RULE 10b-5: THE UNCONSTITUTIONALITY AND INEFFICIENCY OF CRIMINAL PROSECUTIONS FOR INSIDER TRADING

Jurisprudential maxims and constitutional principles demand that no crime be defined except by law.¹ Both the ancient maxim of *nullum crimen sine lege* and the constitutional requirements of due process require precisely drafted criminal laws in order to avoid the arbitrary interpretation of the law by judge and jury and to permit citizens to behave in conformity with the requirements of the law.² Despite these demands, certain statutes continue to regulate economic activities by broadly defining criminal acts. The broad design of these statutes enables the regulators to proscribe a variety of acts which threaten the proper functioning of the economic order, yet are incapable of specific proscription.³ The Securities Exchange Act of 1934,⁴ provisions of which are designed to proscribe the use of fraudulent schemes in the purchase or sale of securities, typifies such a statute. The drafters of these provisions adopted broad language applicable to any fraudulent securities activity in order to reach the unanticipated schemes of clever investors. When the drafters made a wilfull violation of these provisions a crime under the Act,⁵ they undermined the principles of jurisprudence

¹ See Gordon, *Crimes without Laws?*, 11 JUR. REV. 214 (1966) (discussing the principle of *nullum crimen sine lege*, or "no crime without law"). Gordon finds the importance of *nullum crimen* in "its corollary that the criminal law should be clearly defined and certain, so that arbitrary imposition of punishment is avoided, and citizens may be able to ascertain whether their proposed behavior is criminal." *Id.* at 214.

² *Id.* at 214-15.

³ See generally Kadish, *Criminal Sanctions for Economic Regulations*, 30 U. CHI. L. REV. 423, 427 (1962).

⁴ 15 U.S.C. § 77a, *et. seq.* (1976).

⁵ 15 U.S.C. § 78ff (1976).

implicit in the constitutional demand for a definite and certain criminal law. Moreover, the courts' subsequent expansion of the scope of these provisions in criminal cases has further strained demands for certainty in the criminal law. Criminal liability for insider trading, which was created through expansive statutory interpretations in civil cases, is an example of the inappropriate and potentially unconstitutional extension of these antifraud provisions.

This comment discusses whether criminal prosecution of insider trading under Rule 10b-5 is constitutionally defective. First, the historical development of the crime of insider trading is analyzed by focusing on the relevant antifraud provisions and their judicial interpretation. Second, the due process requirement of notice and its relation to the crime of insider trading are discussed. This notice requirement eventually led to an attack, on grounds of vagueness, of Rule 10b-5. Third, therefore, this comment will consider the early cases that dealt with the problem of notice and Rule 10b-5 in any criminal context. The analysis will focus on the crime of insider trading and the answers to the vagueness attack given by the Second Circuit⁶ and by the Supreme Court⁷ in the *Chiarella* cases. Fourth, the courts' use of Rule 10b-5 to criminalize insider trading is compared to the analytical approach adopted by an English court in *Shaw v. Director of Public Prosecutions*.⁸ Fifth, the practical problems encountered with criminal prosecutions under Rule 10b-5 for insider trading are discussed. This final section will focus on the general inefficiency and inappropriateness of the criminal sanction in the attempt to control insider trading through Rule 10b-5.

I. DEVELOPMENT OF THE CRIME OF INSIDER TRADING

The federal regulatory effort to eliminate fraud in securities transactions began with the adoption of the Securities Act of 1933⁹ and its three main antifraud provisions, sections 11,¹⁰ 12(2),¹¹ and 17(a).¹² The

⁶ *United States v. Chiarella*, 588 F.2d 1358 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).

⁷ *Chiarella v. United States*, 445 U.S. 222 (1980).

⁸ [1961] 2 All E.R. 446.

⁹ 15 U.S.C. § 77a *et. seq.* (1976).

¹⁰ 17 U.S.C. § 77k (1976). Section 11 provides civil liabilities for the inclusion of an untrue statement of material fact in any part of the registration statement required under the Act.

¹¹ 17 U.S.C. § 77l (1976). Section 12(2) provides civil liabilities for the sale or offer of a security in connection with a prospectus or other communication containing an untrue statement of material fact.

¹² 15 U.S.C. § 77q(a) (1976). Section 17(a) provides:

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

end-product of the twenty volume Pecora Investigation,¹³ these provisions represent the initial federal response to the widespread fraud, most evident in the omission of relevant information in the sale of worthless securities to public investors.¹⁴ The adoption of the Securities Exchange Act of 1934¹⁵ extended these protections to securities traded on the national securities exchanges. The Act employed sections 10(b) and 16(b) as its main tools to combat securities fraud. While section 16(b) is specifically drafted to reach "short-swing" insider trading,¹⁶ section 10(b) is broader and more imprecise, proscribing manipulation in connection with the purchase or sale of any security.¹⁷ The general terms of section 10(b) embody the intent of Congress to promote fairness in securities transactions.¹⁸

Despite the breadth of its terms and intended purposes, section

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- (1) to employ any device, scheme, or artifice to defraud, or
 - (2) to obtain money or property by means of any untrue statement of a material fact or any omission 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
 - (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

¹³ *Stock Exchange Practices: Hearings on S. Res. 84 (72d Cong.) and S. Res. 56 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st & 2d Sess. (1933-34).

¹⁴ 1 A. BROMBERG, *SECURITIES LAW: FRAUD* § 2.2 at 21 (1977). Professor Bromberg, a noted scholar of Rule 10b-5, is the author of a four volume treatise on the Rule.

¹⁵ 15 U.S.C. § 78a *et. seq.* (1976).

¹⁶ 15 U.S.C. § 78p (1976). Section 16(b) provides:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him for any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within a period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months.

This section operates automatically to protect stockholders of a corporation against shortswing (within the statutory six month period) speculation and trading by insiders holding nonpublic information. Congress deemed this protection necessary to protect aggrieved stockholders from the inequities created by insiders, including directors, officers and principal shareholders, who speculated in their corporation's stock without disclosing all information relevant to their trading activity. *See Smolowe v. Delendo Corp.*, 135 F.2d 231, 235-236 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

¹⁷ 15 U.S.C. § 78j(b) (1976):

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 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.

¹⁸ *See SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir.) (en banc), *cert. denied*, 394 U.S. 976 (1968).

10(b) met little opposition during congressional debate. Out of almost 1,000 pages of transcripts of the House hearings, the combined references to section 10(b) (at the time, section 9(c)) would barely fill a page.¹⁹ What little the record does provide clearly indicates that section 10(b) was designed to be expansive.²⁰ One of the central figures in the drafting of the Securities Exchange Act, Thomas G. Corcoran, explained that

Subsection (c) [referring to section 9(c), later section 10(b) in its final form] says, "Thou shalt not devise any other cunning devices." Of course subsection (c) is a catch-all clause to prevent manipulative devices[.] I do not think there is any objection to that kind of a clause. The Commission should have the authority to deal with new manipulative devices.²¹

After Corcoran's testimony, and prior to its enactment as section 10(b), the provision was broadened to include transactions in unlisted securities and encompass deceptive as well as manipulative devices.²² Thus, the limited legislative history available indicates that unlike section 16(b), Congress did not, with section 10(b), specifically ban insider trading.²³ Rather than enumerating the specific deceptive or manipulative practices intended to be prohibited by section 10(b), Congress established a flexible statute enabling the Securities and Exchange Commission (SEC) to use its rulemaking authority to reach unapproved practices.²⁴

The SEC exercised this authority in 1942 by promulgating Rule X-10B-5, now Rule 10b-5.²⁵ Drafted and adopted in a period of economic recovery, the Rule responded to market practices in which underpriced securities were bought from unknowing stockholders by informed insiders who reaped the benefit of future increases in the value of the stock.²⁶

¹⁹ 1 A. BROMBERG, *supra* note 14, § 2.2(330) at 22.2.

²⁰ *Id.*, § 2.2(332) at 22.4.

²¹ *Id.* (quoting *Stock Exchange Regulation, Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934) (statement of Thomas G. Corcoran)).

²² *Id.*, § 2.2(232) at 22.4.

²³ W. PAINTER, *FEDERAL REGULATION OF INSIDER TRADING* 19 (1968).

²⁴ *Id.*

²⁵ 17 C.F.R. § 240.10b-5 (1980). Rule 10b-5 now provides, in pertinent part, that [i]t 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 necessary in order to make the statements made, in 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.

²⁶ 1 A. BROMBERG, *supra* note 14, § 2.2(420) at 22.8-9. While the Rule was adopted at least in part as a response to insider trading, there is no indication on the face of the rule that

Until the adoption of this provision, the rules proscribing fraud in the purchase of securities had applied only to brokers and dealers. By combining the jurisdictional language of section 10(b) with the substantive language of section 17(a) of the 1933 Act,²⁷ Rule 10b-5 reached fraud committed by "any person" in the "purchase or sale" of any security.²⁸ As evidenced by the Commission's release issued contemporaneously with the rule,²⁹ 10b-5 represented a deliberate effort by the SEC to reach fraud by purchasers as well as fraud by sellers,³⁰ within the statutory framework of section 10(b).

The reach of section 10(b) and Rule 10b-5 has become even more expansive through the course of judicial interpretation. The expansion of these antifraud provisions through the judicial process occurred as a result of less strict adherence to traditional canons of statutory construction³¹ and greater reliance on interpretation of congressional intent as expressed in the Securities Exchange Act of 1934. Guided by the broad congressional mandate to "insure the maintenance of fair and honest markets in . . . [securities] transactions,"³² the courts have modified the common law standard of deceptive conduct to protect the interests of

it was meant to proscribe insider trading. While the SEC may have been "responding" to the trading activity of insiders, this response was not translated into a specific regulatory prohibition of insider trading.

²⁷ See note 12 *supra*.

²⁸ W. PAINTER, *supra* note 23, at 20.

²⁹ SEC Release No. 3230 (May 21, 1942): "The new rule 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."

³⁰ 1 A. BROMBERG, *supra* note 14, § 2.2(420) at 22.7.

³¹ The Supreme Court refused to accept the ancient canons of "*ejusdem generis*" and "*expressio unius est exclusio alterius*" in an interpretation of section 2(1) of the Securities Act of 1933 in *SEC v. Joiner Corp.*, 320 U.S. 344 (1943). Section 2(1) of the Act defines the term "security," specifically including under that definition fractional interests in oil and gas leaseholds. *Joiner* presented the question of whether the maxim "*expressio unius est exclusio alterius*" should be applied to exclude sales of nonfractional oil and gas leaseholds from the operation of the Act, since such leaseholds were not expressly included in the definition of a security as were fractional leaseholds. Replying to the argument that the doctrine of *expressio unius* must apply, the Court observed that:

Some rules of statutory construction come down to us from sources that were hostile to the legislative process itself and thought it generally wise to restrict the operation of the act to its narrowest possible compass. However well these rules may serve at times to aid in deciphering legislative intent, they have long been subordinated to the doctrine that courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text in so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy.

Id. at 350-51. The Court also refused to invoke the *ejusdem generis* rule to constrict the more general term, in this case, "security," to the specific terms which follow. *Id.*

Professor Bromberg notes that the history of Rule 10b-5 is a "massive rejection" of the doctrine of *expressio unius est exclusio alterius*. 1 A. BROMBERG, *supra* note 14, at 27.

³² 15 U.S.C. § 78(b) (1976).

the investing public.³³ In the past,³⁴ the Supreme Court pursued this purpose by broadly construing section 10(b), as it did in *Superintendent of Insurance of New York v. Bankers Life & Casualty Co.*³⁵ In that case, the Court rejected a narrow reading of section 10(b) that did not protect a defrauded corporate seller of Treasury bonds when the sale did not take place through an organized securities exchange or through an organized over-the-counter market. The Court held that the Act protected corporate as well as individual investors in transactions which were not conducted over organized markets. In so holding, the Court declared that it would "not read section 10(b) as narrowly as the Court of Appeals: it is not 'limited to preserving the integrity of the securities markets' . . . , though that purpose is included. Section 10(b) must be read flexibly, not technically and restrictively."³⁶

Such broad readings of section 10(b) transform the provision into a device which applies to almost any scheme that interferes with the fair and efficient operation of the securities market; whether or not that scheme constitutes traditionally fraudulent activity.³⁷ Traditional re-

³³ See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d at 854-55: "In an enforcement proceeding for equitable or prophylactic relief, the common law standard of deceptive conduct has been modified in the interests of broader protection for the investing public so that negligent insider conduct has become unlawful."

³⁴ In more recent years, the Court has slowed the broadening of section 10(b) and Rule 10b-5 liability, at least in its civil incarnations. As described by Harvey Pitt,

Rule 10b-5 has, for many years, served as a foundation for an aggressive enforcement program under the federal securities laws by both the Commission and private litigants. Prior to 1975, the rule had been interpreted broadly to encompass both novel and a typical [sic] situations as well as garden variety securities frauds. Although the rule continues to possess considerable vitality, there can be little question that recent Supreme Court decisions have significantly curtailed the responsiveness with which the judiciary previously viewed Rule 10b-5. . . . The apparent intent of the Supreme Court to reduce the flexibility of Rule 10b-5 and to introduce a greater degree of certainty as to the coverage of the rule is not likely to be accomplished in the absence of further Supreme Court interpretation. . . .

Pitt, *Rule 10b-5: Another Year of Continued Confusion*, in 12 SEC '79, 85, 103 (H. Seligman ed. 1979). However, earlier civil interpretations of the Rule which greatly expanded its substantive scope are still intact after the recent Supreme Court decisions, and these interpretations continue to be applied, without reservation, in the criminal context. In no sense can these recent developments be characterized as a substantive narrowing of the Rule.

In 1975, the Court, in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), limited private actions under 10b-5 to a purchaser or seller of securities. In 1976, the Court, in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), held that in a civil damage action under 10b-5 a showing of scienter was necessary to recovery. Most recently, in 1980, the Court, in *Chiarella v. United States*, 445 U.S. 222 (1980), held that a § 10(b) duty to disclose does not arise from mere possession of nonpublic market information.

³⁵ 404 U.S. 6 (1971).

³⁶ *Id.* at 12.

³⁷ Professor Bromberg observes that "the courts and the SEC interpret the Rule so loosely that it [the "fraud" prohibited by Rule 10b-5] is closer to unfairness than to what either

quirements such as reliance³⁸ and financial motive³⁹ have been abandoned in favor of a more flexible approach.⁴⁰ Only recently has the requirement of breach of a legal or equitable duty been revitalized.⁴¹ It is true that each scheme to defraud might present a new form of deception in a setting that does not fit neatly into traditional categories of deceptive conduct. This problem, however, is not unique to fraud in the context of securities transactions. The typical state statute providing criminal sanctions for deceptive practices is considerably more definite

lawyers or laymen usually think of as fraud." 1 A. BROMBERG, *supra* note 14, § 1.1 at 5 (footnotes omitted).

That the statute embodies a concept of fairness rather than fraud appears in an interpretation offered by the Seventh Circuit in *Kohler v. Kohler Co.*, 399 F.2d 634, 642 (7th Cir. 1963): "The statute and the rule basically call for fair play and abstention on the part of the corporate insider from taking advantage of the uninformed outsider or minority stockholder."

³⁸ The requirement of reliance was abandoned by the Court in favor of the concept of materiality, at least in private damage suits. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). The Court held that:

(u)nder the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. . . . This obligation to disclose and the withholding of a material fact establish the requisite element of causation in fact.

Id. at 154.

³⁹ Professor Bromberg notes that "(a) 10b-5 transgression can occur without economic motive or purpose." 3 A. BROMBERG, *supra* note 14, § 8.4(554) at 204.201 (citing *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d at 862). Bromberg goes on to note that "even in a criminal case, motive is not essential," citing *United States v. Simon*, 425 F.2d 796, 808-810 (2d Cir. 1969), *cert. denied*, 397 U.S. 1006 (1970) *id.* In *Simon*, the criminal convictions of accountants who had certified misleading financial statements were upheld even though the court found no personal financial motivation or other "ordinary commercial motivation."

⁴⁰ This flexible approach and its departure from the traditional concept of fraud were adopted in *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963):

It is clear that the statute was intended to create a form of fiduciary relationship between so-called corporate "insiders" and "outsiders" with whom they deal in company securities which places upon the insider duties more exacting than mere abstention from what is generally thought to be fraudulent practices. If so, the question arises: What are the limits of those duties? We are satisfied that the answer cannot be confined to an abstract rule but must be fashioned case by case as particular facts dictate.

Id. at 637.

⁴¹ The Court resurrected and revitalized the concept of duty when it held in *Chiarella v. United States*, 445 U.S. 222, that there could be no fraud under 10b-5 absent a duty to disclose:

Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information.

Id. at 234-35. Thus, when the Court notes in dicta that "what it [§ 10(b)] catches must be fraud," it is simply reaffirming the role of the traditional duty of disclosure associated with one in a fiduciary or confidential relationship. In this limited context, the Court did not hold that all the traditional requirements of common law fraud must be met in a Rule 10b-5 prosecution.

and narrow in scope than is Rule 10b-5.⁴² Thus, while the states reach deceptive conduct with narrowly drafted statutes,⁴³ the federal courts

⁴² For a typical criminal deceptive practices statute, see ILL. REV. STAT. ch. 38, § 17-1 (1979):

§ 17-1. Deceptive practices. (A) As used in this Section. . . :

(iii) To act with the "intent to defraud" means to act wilfully, and with the specific intent to deceive or cheat, for the purpose of causing financial loss to another, or to bring some financial gain to oneself. It is not necessary to establish that any person was actually defrauded or deceived.

(B) General Deception

A person commits a deceptive practice when, with intent to defraud:

(a) He causes another, by deception or threat to execute a document disposing of property or a document by which a pecuniary obligation is incurred, or

(b) Being an officer, manager or other person participating in the direction of a financial institution, he knowingly receives or permits the receipt of a deposit or other investment, knowing that the institution is insolvent, or

(c) He knowingly makes or directs another to make a false or deceptive statement addressed to the public for the purpose of promoting the sale of property or services, or

(d) With intent to obtain control over property or to pay for property, labor or services of another he issues or delivers a check or other order upon a real or fictitious depository for the payment of money, knowing that it will not be paid by the depository. Failure to have sufficient funds or credit with the depository when the check or other order is issued or delivered is prima facie evidence that the offender knows that it will not be paid by the depository, and that he has the intent to defraud; . . .

(C) Deception on a Bank or Other Financial Institution

False Statements

1) Any person who, with the intent to defraud, makes or causes to be made, any false statement in writing in order to obtain an account with a bank or other financial institution, or to obtain credit from a bank or other financial institution, knowing such writing to be false, and with the intent that it be relied upon, is guilty of a Class A misdemeanor.

For purposes of this subsection (C), a false statement shall mean any false statement representing identity, address, or employment, or the identity, address or employment of any person, firm or corporation.

Possession of Stolen or Fraudulently Obtained Checks

2) Any person who possesses, with the intent to defraud, any check or order for the payment of money, upon a real or fictitious account, without the consent of the account holder, or the issuing financial institution, is guilty of a Class A misdemeanor. . . .

3) Possession of Implements of Check Fraud. Any person who possesses, with the intent to defraud, and without the authority of the account holder or financial institution any check imprinter, signature imprinter, or "certified" stamp is guilty of a Class A misdemeanor. . . .

Possession of Identification Card

4) Any person, who with the intent to defraud, possesses any check guarantee card or key card or identification card for cash dispensing machines without the authority of the account holder or financial institution, is guilty of a Class A misdemeanor. . . .

⁴³ Professor Bromberg notes that "(a)lthough it is difficult to generalize because of local variations, state fraud seems narrower than 10b-5 in most instances." 2 A. BROMBERG, *supra* note 14, § 2.7(1) at 56 n.150 (new matter, at 390). The states have also been particularly more successful than the SEC and Congress in proscribing insider trading with a narrowly drafted statute. In particular, California has imposed a statutory duty on insiders to disclose when trading on inside information:

It is unlawful for an issuer or any person who is an officer, director or controlling person of an issuer or any other person whose relationship to the issuer gives him access, directly or indirectly, to material information about the issuer not generally available to the public, to purchase or sell any security of the issuer in this state at a time when he knows material information about the issuer gained from such relationship which would

continue to expand the already broad language of 10b-5 to reach unanticipated forms of deception.⁴⁴ Thus, the antifraud provisions of the Exchange Act have developed, through expansive judicial interpretation, into a means of policing the securities markets by reaching not only traditional fraudulent activity,⁴⁵ but also by reaching a new class of fraud which impacts the operation of the securities markets without necessarily satisfying the elements of common law fraud.⁴⁶

Consistent with this broad construction of the antifraud provisions, the courts expanded Rule 10b-5, through continuous judicial interpretation in civil cases,⁴⁷ to proscribe insider trading.⁴⁸ The historical foundation of this proscription was established by the SEC's interpretation of

significantly affect the market price of that security and which is not generally available to the public, and which he knows is not intended to be so available, unless he has reason to believe that the person selling to or buying from him is also in possession of the information.

CAL. CORP. CODE § 25402 (West 1977). This California provision has been incorporated in the American Law Institute's proposed Federal Securities Code. ALI FED. SECURITIES CODE § 1603 (1980).

⁴⁴ See, e.g., *A. T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967):

[We do not] think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that 'is usually associated with the sale or purchase of securities.' We believe that § 10(b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws.

⁴⁵ That the language of section 10(b) encompasses more than simply common law fraud was noted in *Ellis v. Carter*, 291 F.2d 270, 274 (9th Cir. 1961):

Section 10(b) speaks in terms of the use of "any manipulative device or contrivance" in contravention of rules and regulations as might be prescribed by the commission. It would have been difficult to frame the authority to prescribe regulations in broader terms. Had Congress intended to limit this authority to regulations proscribing common-law fraud, it would probably have said so. We see no reason to go beyond the plain meaning of the word "any," indicating that the use of manipulative or deceptive devices or contrivances of whatever kind may be forbidden, to construe the statute as if it read "any fraudulent" devices.

⁴⁶ Many of these decisions fail to indicate just which common-law elements are dispensed with. The Fifth Circuit has perhaps stated the greatest detail, sweeping it all away: "(10b-5) greatly expands the protection frequently so hemmed in by the traditional concepts of common law misrepresentation and deceit, the requirement of privity, proof of specific damage, inadequacy of the right of rescission or right to recover up to par value of stock of much greater value. To these difficulties would have to be added the geographical obstacle of suit in a common forum against multi-state defendants scattered as far as the fraudulent device required."

1 A. BROMBERG, *supra* note 14, § 2.7(1) at 55 n.150 (quoting *Hooper v. Mountain States Securities Corp.*, 282 F.2d 195, 201 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961)). Cf. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (The Court held that § 206 of the Investment Advisers Act of 1940 is not limited to proscription of those acts or omissions traditionally reached under common law fraud. "Fraud, indeed, in the sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue and unconscientious advantage is taken of another." *Id.*). See also 1 A. BROMBERG, *supra* note 14, § 2.7(1) at 55 n.1 (discussing *SEC v. Capital Gains*).

⁴⁷ See W. PAINTER, *supra* note 23, at 21-22. Painter argues that it was only through an evolutionary administrative and judicial expansion of 10b-5 that it became useful as a tool for

Rule 10b-5 in *Ward LaFrance Truck Corporation*,⁴⁹ and by judicial application of Rule 10b-5 to insider trading in *Kardon v. National Gypsum Co.*,⁵⁰ and in *Speed v. Transamerica Corp.*⁵¹ While these opinions are important for historical purposes in tracing the substantive expansion of Rule 10b-5 in the context of civil liability for insider trading, the SEC did not establish that Rule 10b-5 would serve as the definitive prohibition of insider trading until the decision of *In re Cady, Roberts & Co.*⁵² This

proscribing trading by insiders who relied on confidential information in making their purchases.

⁴⁸ In general terms, insider trading refers to the practice of trading in a corporation's stock by a corporate insider, usually, but not exclusively, a director or other officer, who has knowledge of information likely to influence the value of the stock when made public.

⁴⁹ 13 S.E.C. 373 (1943). The SEC in *Ward LaFrance* applied the newly adopted 10b-5 to reach a purchase by Ward LaFrance officers of the minority shareholders' interest in the corporation. The officers purchased without disclosing recently increased earnings and without revealing their intent to liquidate the corporation. *Id.* While holding that Rule 10b-5 applied to this transaction, *Ward LaFrance* did little more than include the common law "special facts" doctrine of *Strong v. Repide*, 213 U.S. 419 (1909), within the meaning of section 10(b)'s "deceptive device" language. See Manne, *Insider Trading and the Administrative Process*, 35 GEO. WASH. L. REV. 473, 478 (1967). Professor Manne argues that, at the time, commentators viewed *Ward LaFrance* as an adoption of the "special facts" doctrine. This doctrine was limited to those situations involving the most flagrant breaches of fiduciary duty in direct purchases between insiders and investors, usually in the context of closely held corporations. See W. PAINTER, *supra* note 23, at 17-18. For this reason, the doctrine was ineffective in reaching insider trading involving publicly held and nationally traded shares. *Id.*

Professor Manne argues further that until 1947, there was no general rule against insider trading, and cites SEC v. Chenery Corp., 318 U.S. 80 (1943), as indirect authority for this proposition. Manne, *supra*, at 478 n.43. Regardless of the validity of this analysis, it is apparent that *Ward LaFrance* was merely the beginning of the subsequent growth of Rule 10b-5.

⁵⁰ 73 F. Supp. 798 (E.D. Pa. 1947). The *Kardon* court held that section 10(b) and Rule 10b-5 "apply to directors and officers who, in purchasing the stock of the corporation from others, fail to disclose a fact coming to their knowledge by reason of their position which would materially affect the judgement of the other party to the transaction." *Id.* at 800. Thus, insiders, here defined to be directors and officers, were brought under the umbrella of 10b-5 civil liability when they failed to disclose material facts to the sellers of securities.

⁵¹ 49 F. Supp. 808 (D. Del. 1951). The *Speed* court defined the duty imposed on corporate insiders:

It is unlawful for an insider, such as a majority stockholder, to purchase the stock of a minority stockholder without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgement of sellers.

Id. at 828-829.

While *Speed* may be limited to a situation involving a majority shareholder who purchases, outside the organized security exchanges, the interest of the minority shareholders in order to capture the value of the corporation's assets, the language of its holding went beyond any previous interpretation of 10b-5 and provided a basis for future expansive interpretation in cases to follow. See 1 A. BROMBERG, *supra* note 14, § 3.2(300) at 65. In this instance, however, the court viewed 10b-5 as "broadly remedial," and extended that rule to provide liability within the limited context of a majority shareholder so purchasing the interest of the minority. 49 F. Supp. at 829.

⁵² 40 S.E.C. 907 (1961). *Cady, Roberts & Co.* grew out of an action brought by the SEC to discipline a partner of a registered broker-dealer firm for violations of section 10(b) and Rule

landmark opinion, written by William Carey, then the Commissioner of the SEC, imposed an obligation on insiders to disclose material information or refrain from trading, even when there was no pre-existing fiduciary relationship between the insider and the parties with whom he traded.⁵³ In establishing this obligation to the market, Commissioner Carey relied on the broad, remedial provisions of the Securities Exchange Act; provisions unconstrained in his analysis by the narrower and more technical variety of common law fraud.⁵⁴ Carey reiterated his concern that the antifraud provisions be construed flexibly to reach multiple forms of deception which are incapable of specification before they occur, but which must be proscribed if the SEC is to ensure a fair securities market.⁵⁵

The growing proscription of insider trading through the expansion of 10b-5 reached its zenith⁵⁶ in *SEC v. Texas Gulf Sulphur Co.*⁵⁷ In *Texas Gulf Sulphur*,⁵⁸ the Second Circuit declared the *Cady Roberts & Co.* rule,

10b-5. The partner, acting on information received from a director of the corporation about an impending dividend reduction, proceeded to sell shares in the corporation from discretionary accounts of firm customers, knowing that the information had not yet been made public. Imposing a 10b-5 duty to disclose to this broker, the Commission virtually assured that Rule 10b-5 would serve as the definitive tool in an attack on all insider trading, imposing an obligation to disclose or refrain from trading regardless of any fiduciary relationship between the parties involved.

⁵³ 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 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. . . . [O]ur task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading its securities.

In re Cady, Roberts & Co., 40 S.E.C. at 912 (footnotes omitted).

⁵⁴ "Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5, issued under that Section, are broad remedial provisions aimed at reaching misleading or deceptive activities, whether or not they are precisely and technically sufficient to sustain a common law action for fraud and deceit." *Id.* at 910 (footnotes omitted).

⁵⁵ "These anti-fraud provisions are not intended as a specification of the particular acts or practices which constitute fraud, but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors or others." *Id.* at 911 (footnote omitted).

⁵⁶ Manne, *supra* note 49, at 474.

⁵⁷ 401 F.2d 833.

⁵⁸ The *Texas Gulf Sulphur* litigation grew out of the massive Timmins ore find and the subsequent trading by corporate insiders and others in the stock of Texas Gulf prior to the public announcement of this find. After the first successful drill hole was completed by Texas Gulf near Timmins, Ontario, in late 1963, and after it became clear that Texas Gulf had made what was apparently one of the largest ore finds in history, the corporation undertook tight security measures to prevent news of the find from leaking out. It was after this find and after the institution of security measures that several officers, directors and employees of Texas Gulf bought shares in the company or exercised stock options given by the company. This practice was continued by these individuals until April 16, 1964, when the announcement by Texas Gulf officials of this major ore find was made, and prices of the stock made substantial advances. The SEC subsequently filed suit, asking for both injunctive and restitu-

which proscribed trading by one who has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone,"⁵⁹ to be the "essence"⁶⁰ of Rule 10b-5. In *Texas Gulf*, what had originated as a rule primarily designed to prevent fraud by brokers and dealers became a device for assuring "equal access to material information."⁶¹ To implement this policy of equal access, the court relied upon *Cady, Roberts & Co.* to declare that not only are the traditional corporate insiders, management and directors precluded from dealing on inside information, but that

anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or if he chooses not to do so, must abstain from trading in or recommending the securities while such inside information remains undisclosed.⁶²

Having identified a duty owed to the open market by anyone in possession of material inside information, the *Texas Gulf Sulphur* court then established a test for assessing when information was material. The court found any fact to be material "which in reasonable and objective contemplation *might* affect the value of the corporation's stock or securities."⁶³ Such facts, the court held, included not only information pertaining to a corporation's earnings and distributions, but also those facts which affect the "*probable future* of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities."⁶⁴ The court essentially offered a calculus of expected probabilities that the possessor of inside information must properly evaluate in determining whether the information is such that Rule 10b-5 demands disclo-

sive relief, against the individuals and the corporation, alleging violations of Rule 10b-5 where the parties traded on material facts without disclosing such facts to the sellers of Texas Gulf stock.

⁵⁹ 401 F.2d at 848 (quoting *In re Cady, Roberts & Co.*, 40 S.E.C. at 912).

⁶⁰ *Id.* at 844.

⁶¹ *Id.* The *Texas Gulf Sulphur* court referred to the general congressional purpose to insure that all members of the investing public face identical market risks:

The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks,—which market risks include, of course the risk that one's evaluative capacity or one's capital to put at risk may exceed another's capacity or capital.

Id. at 851-52.

⁶² *Id.* at 848 (emphasis added). The court made clear that it was expanding the traditional concept of a corporate insider with this statement: "[i]nsiders, as directors or management are, of course, by this Rule, precluded from so unfairly dealing, but the Rule is also applicable to one possessing the information who may not be strictly termed an 'insider' within the meaning of Sec. 16(b) of the Act." *Id.* (citation omitted).

⁶³ *Id.* at 849.

⁶⁴ *Id.*

sure prior to trading.⁶⁵ The court explicitly adopted this probabilistic approach with this passage:

In each case, then, whether facts are material within Rule 10b-5 when the facts relate to a particular event and are undisclosed by those persons who are knowledgeable thereof will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.⁶⁶

While courts that make the assessment of the magnitude of the particular event discounted by the probability that the event will occur operate from a position of hindsight, the insider must follow this calculus without the certainty that such hindsight provides.⁶⁷ At best, then, the insider⁶⁸ confronting the issue of 10b-5 liability is faced with a calculus of uncertainties which become certainties only after he has made his decision to trade or to refrain from trading.⁶⁹

Placing the insider in a position of uncertainty with respect to his liability under section 10(b) and Rule 10b-5 may be an acceptable ap-

⁶⁵ Professor Bromberg criticizes this test of materiality, arguing that the result, "in view of the way market professionals and short term traders sometimes react to relatively slight bits of information—seems to be to set a regrettably low threshold of materiality." 2 A. BROMBERG, *supra* note 14, § 7.4(3)(c) at 168.4.

⁶⁶ 401 F.2d at 849.

⁶⁷ Professor Bromberg discusses the problems with the *Texas Gulf* test and its reliance upon hindsight in assessing materiality:

The court does not refine the probability factor any further; we cannot tell whether it has in mind odds better than 50-50 or 75-25, or something else. A probability approach realistically simulates much investor judgement, which is probabilistic in some degree. But the court gives no indication of the relevant odds and creates a test which will be difficult to apply fairly and which lends itself easily to distortion by hindsight, in one direction if the event does in fact occur, and in opposite direction if it does not.

2 A. BROMBERG, *supra* note 14, § 7.4(3)(f) at 169.

Professor Bromberg prefers a rule of thumb which would measure materiality "in terms of probable effect on security prices. A predicted shift of a few percentage points seems non-material for most stocks; 20% would be material for nearly any security." *Id.*, § 7.4(3)(c) at 168.6. The advantage of such an approach, according to Bromberg, "would be to give companies and insiders a better basis for judging when they have material information, when they should release it, and when it is safe for them to trade." *Id.*

⁶⁸ The insider not only may have difficulty determining when information is material, he also may have difficulty determining whether or not he is in fact an "insider" subject to the Rule. The ambiguity of this passage from Bromberg illustrates the problem:

People have been agonizing for years over the question, "Who is an insider?" The answer is not to be found in organizational charts or other well-defined relationships. It is to be found in "access" and "unfairness," . . . (T)he crucial criterion is "access." This means something more than possession of the information, but how much more is not yet clear. Probably it means possession intended to fulfill a corporate purpose [of the company to which the information relates].

Id., § 7.4(6)(b) at 180 (footnotes omitted).

⁶⁹ The difficulty of making the decision while confronted with the uncertainties and pressures of an active market is noted by Professor Bromberg, who states that "[i]t is hard enough for a lawyer, let alone a businessman, to fix the point of materiality while caught up in the flow of events." *Id.*, § 7.4(6)(c) at 186.

proach with regard to civil liability for violations of the Rule. The lower federal courts and Congress have declared that the disruption of fair and efficient operation of the securities market, caused by insider trading on concealed information, is a significant problem.⁷⁰ In such a situation, where an efficient market is threatened,⁷¹ and where the insider always has the option of not trading,⁷² it may be appropriate to place the risk of erroneous guessing on the insider.⁷³ Thus, when the insider engages in market activity that is potentially disruptive, he takes the risk that the courts or the Commission will find his activity disruptive under Rule 10b-5.

When both civil remedies and criminal sanctions are authorized under the same statutes,⁷⁴ the enforcement of that statute can present constitutional difficulties, as illustrated in the remainder of this comment. Violation of either section 10(b) or Rule 10b-5 subjects the violator not only to civil sanction, but may also be a crime under section

⁷⁰ The *Texas Gulf Sulphur* court, quoting H.R. REP. NO. 1383, 73d Cong., 2d Sess. 11 (1934), stated:

The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value.

401 F.2d at 858.

⁷¹ Much of the literature critical of the development of Rule 10b-5 as a prohibition on insider trading argues that insider trading creates significant economic benefits and in fact contributes to the efficiency of the market by insuring more rapid dissemination of information. See, e.g., H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966); Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5*, 59 NW. U.L. REV. 185, 208-214 (1964). Professor Bromberg notes, however, that none of the arguments advanced by these authors strikes an economist as very probable. The weight of authority as well as the weight of economic theory rests with those who argue that the economic harm caused by insider trading outweighs any of the incidental benefits which might accompany that trading. See 2 A. BROMBERG, *supra* note 14, § 7.4(6)(b) at 179 n.166.

⁷² Professor Bromberg notes:

Much of the rhetoric about 10b-5 in the open market has proceeded as if there were only two choices for the person with inside information: to reveal it or to violate the Rule. Since revealing it may injure the corporation . . . and be beyond the scope of the insider's authority . . . , the conclusion follows that 10b-5 cannot require disclosure. Apart from the difficult balancing of individual, corporate and market elements inherent in such an argument, it ignores the third alternative: not to trade. The last course will often be the safest and most conservative one for the insider, and it is doubtful that either he or the economy will suffer from it, for only short periods—weeks or days, sometimes just hours—are usually involved.

2 A. BROMBERG, *supra* note 14, § 7.4(6)(a) at 178 (footnote omitted).

⁷³ The court in *Texas Gulf Sulphur* placed the burden of guessing wrong upon the insider by establishing that "(e)ven if insiders were in fact ignorant of the broad scope of the Rule and acted pursuant to a mistaken belief as to the applicable law such an ignorance does not insulate them from the consequences of their acts." 401 F.2d at 852 n.15.

⁷⁴ Cf. *United States v. United States Gypsum Co.*, 438 U.S. 422, 435-39 (1978) (Sherman Act authorizes both civil remedies and criminal sanctions with regard to the same generalized definitions of the conduct proscribed.)

32(a), the penalty provision of the Securities Exchange Act of 1934.⁷⁵ While the number of reported criminal cases involving criminal violations of 10b-5 is not large,⁷⁶ the criminal sanction is all too frequently employed in conjunction with Rule 10b-5. The problems that repeatedly appear within the limited number of reported criminal 10b-5 cases, particularly in those cases involving insider trading, merit a closer analysis than has been provided in the past.⁷⁷ Ironically, such an analysis is critically important today because both an SEC commissioner⁷⁸ and the

⁷⁵ Section 32(a), 15 U.S.C. § 78ff (1976), provides, in pertinent part, the following:

Any person who willfully violates any provision of this chapter . . . , or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter, . . . shall upon conviction be fined not more than \$10,000, or imprisoned not more than five years, or both, except that when such person is an exchange, a fine not exceeding \$500,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.

⁷⁶ Professor Loss provides the most extensive collection of 10b-5 criminal cases to 1961, noting that there is little point in collecting those beyond 1961, due to the high number that produced no opinions, usually due to guilty pleas:

United States v. Griswold, 5 SEC Jud. Dec. 305 (N.D. Ohio 1947) (conviction based on outsider's acquiring liquor company's shares principally from innkeepers by falsely representing that they were worthless after exercise of the purchase rights granted by issuer to buy its whiskey inventory); United States v. Rubrecht, Litig. Rel. 366, 5 SEC Jud. Dec. 181, 15 SEC Ann. Rep. 253 (W.D. Pa. 1947) (motion to dismiss indictment *denied*); United States v. Turner, Litig. Rels. 418, 427 (W.D. Wis. 1947); United States v. Taylor, Litig. Rels. 364, 491 (N.D. Ill. 1949); United States v. Waddy, Litig. Rel. 504, 545 (W.D. Ark. 1949); United States v. Hancock, Litig. Rel. 530 (S.D.N.Y. 1949) (involved a scheme whereby an employee of a company which was trustee, sponsor and investment adviser for certain investment funds defrauded the funds by informing a broker-dealer firm and a securities trader of the trustee's plans to buy or sell securities for the portfolios of the funds, so that they could "get ahead" of the trustee in the market); United States v. Davis, Litig. Rels. 568, 587 (W.D. Mo. 1950); United States v. Herald, Litig. Rels. 531, 594 (N.D. Ill. 1950); United States v. Luck, Litig. Rels. 541, 637 (S.D. Fla. 1951); United States v. Swift, Litig. Rels. 805, 827 (S.D. Cal. 1954) (dissemination of false information to newspapers); United States v. Martin, Litig. Rel. 832 (D.N.M. 1954); United States v. Smith, Litig. Rel. 2058 (N.D. Ala. 1961); United States v. Bales, Litig. Rel. 2075 (W.D. Ky. 1961).

3 L. LOSS, SECURITIES REGULATION 1449 n.15 (2d ed. 1961 & 1969 Supp. at 3559).

⁷⁷ Herlands, *Criminal Aspects of the Securities Exchange Act*, 21 U. VA. L. REV. 139 (1934) is still cited as a useful work discussing the criminal penalties associated with the Exchange Act. Professor Bromberg refers to the criminal aspects of 10b-5 as not "particularly extensive or significant," and for that reason only "sketches" those aspects in his discussion. 4 A. BROMBERG, *supra* note 14, § 10.3 at 241.

⁷⁸ In a recent interview with the Bureau of National Affairs, SEC Commissioner Barbara S. Thomas noted that she would like to see Congress impose stricter penalties for insider trading:

I think that the prospect of an SEC injunction, even when coupled with disgorgement of illegal profits and payments of attorneys' fees, simply is not sufficient to deter certain people from insider trading. They feel that if they are caught, they are not much worse off than if they had passed up the opportunity altogether.

I am currently considering ways in which we can increase the deterrent effect of our enforcement actions. Clearly, there ought to be more frequent use of criminal penalties

director of the SEC's Division of Enforcement⁷⁹ have indicated their plans to apply criminal penalties more frequently in an effort to deter insider trading. The central problem ignored in criminal prosecutions of insider trading,⁸⁰ but noted by Judge Kaufman in *United States v. Per-skey*,⁸¹ begins with "the apparent dissonance between the general rule that criminal statutes are to be construed strictly in favor of the accused . . . , and the realization that the civil incarnations of the antifraud provisions have, as remedial legislation, been openly and avowedly construed broadly"⁸² An adequate assessment of the significance of this apparent dissonance begins with an analysis of the constitutional demand for certainty in the criminal law.⁸³

II. VOID-FOR-VAGUENESS: AN EXAMINATION OF THE TRADITIONAL NOTION OF DUE PROCESS

To assure certainty in the criminal law,⁸⁴ the Supreme Court established the void-for-vagueness doctrine. The doctrine is based upon the precept that a criminal statute must be sufficiently definite so as to indi-

⁷⁹ The Bureau of National Affairs made this report of John M. Fedders' first public remarks as Director of the Division of Enforcement at the SEC:

The Commission will "intensify its efforts to detect and prosecute" trading based on non-public information, Fedders pledged. He (Fedders) said the Commission would "not shy away from cases based on circumstantial evidence" if the facts demonstrated that "any person breached a trust, confidence or other duty owed to another" by trading while in possession of inside information.

624 S.E.C. REG. & REP. (BNA) A-5 (Oct. 14, 1981).

⁸⁰ The dual nature of the Sherman Act, which also provides both civil and criminal sanctions, has presented similar problems of interpretation for the courts. The problems were discussed by the Supreme Court in *United States v. United States Gypsum Co.*, 438 U.S. at 435-39:

The Sherman Act, unlike most traditional criminal statutes, does not, in clear and categorical terms, precisely identify the conduct which it proscribes. Both civil remedies and criminal sanctions are authorized with regard to the same generalized definitions of the conduct proscribed—restraints of trade or commerce and illegal monopolization—without reference to or mention of intent or state of mind. . . .

The Act has not been interpreted as if it were primarily a criminal statute; it has been construed to have a 'generality and adaptability comparable to that found to be desirable in constitutional provisions.' *Appalachian Coals, Inc. v. United States*, 288 U.S. 344, 359-360 (1933).

⁸¹ 520 F.2d 283 (2d Cir. 1975).

⁸² *Id.* at 287 (citations omitted).

⁸³ Judge Sneed identified the inconsistency between the demands of the criminal law and the application of 10b-5 in criminal prosecution: "neither section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b), nor Rule 10b-5, 17 C.F.R. § 240.10b-5, are interpreted narrowly when employed as a basis for criminal prosecution, even though a narrow interpretation is ordinarily considered proper with respect to statutes defining crimes" *U.S. v. Charnay*, 537 F.2d 341, 355 (9th Cir. 1976) (Sneed, J., concurring) (citations omitted). This inconsistency will be discussed in detail in the remainder of this comment.

⁸⁴ See H. PACKER, *THE LIMITS OF THE CRIMINAL SANCTION* 93 (1968).

cate what conduct is subject to a penalty.⁸⁵ This doctrine developed through interpretation of the fifth amendment due process requirement during the era of substantive due process.⁸⁶ In this era, the vagueness doctrine was a convenient vehicle for voiding various pieces of regulatory legislation.⁸⁷ Although a product of the era of substantive due process, the vagueness doctrine retains its vitality. Today, the Court usually applies the doctrine in cases involving fundamental personal rights, particularly those enumerated in the first amendment, rather than in cases involving economic regulatory legislation.⁸⁸

This concept of definiteness finds application in two criminal contexts. First, prior to any act by the potential criminal offender, definiteness demands that the criminal law give explicit notice and fair warning sufficient to permit the potential offender to tailor his conduct to meet the requirements of the statute.⁸⁹ Second, at the trial of an accused, definiteness demands that the criminal law provide sufficiently precise standards to guide both court and jury in their determination of whether the accused has in fact violated the statute.⁹⁰ The resultant test is the same in both contexts, however, since a statute which forbids the doing of an act in terms so vague or uncertain that it fails to give a person of ordinary intelligence notice that such an act is forbidden is repugnant to the essential requirements of due process.⁹¹ The Court has held that

it will not do to hold an average man to the peril of an indictment for the unwise exercise of his . . . knowledge involving so many factors of varying effect that neither the person to decide in advance nor the jury to try him after the fact can safely and certainly judge the result.⁹²

⁸⁵ See Note, *Due Process Requirements of Definiteness in Statutes*, 62 HARV. L. REV. 77, 78 (1948).

⁸⁶ The doctrine was first mentioned by the Court in *Ohio ex. rel. Lloyd v. Dollison*, 194 U.S. 445, 450 (1904); it was first squarely recognized in *Waters-Pierce Oil Co. v. Texas* (No. 1), 212 U.S. 86, 108-11 (1909); and it was first invoked to invalidate a statute in *International Harvester Co. v. Kentucky*, 234 U.S. 216 (1914).

Id. at 77.

⁸⁷ See *Champlin Ref. Co. v. Corporation Comm'n.*, 286 U.S. 210 (1932); *Smith v. Cahoon*, 283 U.S. 553 (1931); *Cline v. Frink Dairy Co.*, 274 U.S. 445 (1927); *Connally v. General Constr. Co.*, 269 U.S. 385 (1926); *A.B. Small Co. v. American Sugar Ref. Co.*, 267 U.S. 233 (1925); *United States v. L. Cohen Grocery Co.*, 255 U.S. 81 (1921).

⁸⁸ See Note, *The Void-for-Vagueness Doctrine in the Supreme Court*, 109 U. PA. L. REV. 67, 74 n.38 (1960).

⁸⁹ *Winters v. New York*, 333 U.S. 507, 524 (1948) (Frankfurter, J., dissenting), cited in Note, *The Void-for-Vagueness Doctrine in the Supreme Court*, *supra* note 88, at 68 n.3.

⁹⁰ *Screws v. United States*, 325 U.S. 91, 151-52, 154 (1945) (Roberts, J., dissenting), cited in Note, *The Void-for-Vagueness Doctrine in the Supreme Court*, *supra* note 88, at 68 n.3.

⁹¹ *Papachristou v. City of Jacksonville*, 405 U.S. 156, 163 (1972); *United States v. Harriss*, 347 U.S. 612, 617 (1954); *Lanzetta v. New Jersey*, 306 U.S. 444, 453 (1939); *Champlin Refining Co. v. Corporation Commission of Oklahoma*, 286 U.S. 210, 242 (1931); *Connally v. General Construction Co.*, 269 U.S. 385, 391 (1926).

⁹² *Cline v. Frink Dairy Co.*, 274 U.S. 445, 465 (1927).

Thus, in assessing a claim of statutory vagueness,⁹³ "the applicable test is whether the language conveys 'sufficiently definite warning as to the proscribed conduct when measured by common understanding and practices.' . . . A statute violates due process if 'men of common intelligence must necessarily guess at its meaning and differ as to its application.'" ⁹⁴

In practice, courts have not strictly applied the standard of "common intelligence" and have demanded less definiteness than what the standard seems to require.⁹⁵ Generally, an individual is charged with "such knowledge of a statute's meaning and applicability as he could obtain through competent legal advice, provided that the statute gives him enough warning that he ought reasonably to see the need for obtaining such advice."⁹⁶ Such a standard seems particularly appropriate in the area of economic regulation, where a businessman will often attempt to ascertain his legal rights and duties by consultation with an attorney.⁹⁷ When a criminal statute does not equip a competent attorney to make sufficiently definite predictions of what conduct falls within its proscriptive bounds, the statute fails to satisfy the due process requirement of notice.⁹⁸

Even this test, however, may be applied less strictly than its language demands, particularly in the context of criminal proscription of certain types of business behavior. While "[n]o one may be required at peril of life, liberty or property to speculate as to the meaning of penal statutes,"⁹⁹ it is also true that because "there may be marginal cases in

⁹³ Here, the relevant inquiry is one of the constitutional validity, in the context of a criminal prosecution, of a rule, Rule 10b-5, promulgated pursuant to a statute, section 10(b) of the Exchange Act. In such a circumstance, the rule must meet the same standard of definiteness required of the statute. Herlands, *supra* note 77, at 170. The central concern in this discussion is not with the validity of the Rule as a product of delegation of administrative authority under the Act. As distinguished by Herlands:

The propriety of delegating to administrative bodies the execution of policies and administrative functions defined by statute is well established. In determining the constitutionality of such grants of power, it has been said that "the issue is whether the statutory standard is sufficiently definite for the administrative agency to carry out the legislative will." And for such purposes "the precision of a criminal statute is not required." But a criminal statute must clearly define the nature and the quality of the offense; otherwise it may be declared unconstitutional for ambiguity and indefiniteness. There is logic in holding that the same law may be invalid as a criminal statute but valid as a delegation of administrative power.

Id. (footnotes omitted).

⁹⁴ *United States v. Schwartz*, 454 F.2d 499 (2d Cir. 1972) (citations omitted).

⁹⁵ Note, *Due Process Requirements of Definiteness in Statutes*, *supra* note 85, at 79.

⁹⁶ *Id.* at 80.

⁹⁷ *Id.* at 80 n.18.

⁹⁸ *Id.* at 80.

⁹⁹ *Lanzetta v. New Jersey*, 306 U.S. 444, 453 (1939). *Lanzetta* involved the constitutionality of a criminal conviction under a New Jersey statute making it a crime to be a gangster. A gangster was defined to be any person not engaged in a lawful occupation, known to be a

which it is difficult to determine the side of the line on which a particular fact situation falls is no sufficient reason to hold the language too ambiguous to define a criminal offense."¹⁰⁰ In cases in which the subject matter limits the precision with which the legislature or the administrative agency can identify the proscribed conduct, the court may uphold the necessarily indefinite statute rather than find it unconstitutionally vague and therefore void.¹⁰¹ In the presence of such policy considerations, the court may weigh the indefiniteness of the statute against the economic and social value of maintaining the statute's proscription.¹⁰² In general, public welfare or regulatory offenses do not invoke the same demanding constitutional scrutiny applicable to other offenses.¹⁰³ Thus, a less stringent standard of impermissible vagueness will apply to the rules promulgated under the Securities Exchange Act. To survive the standard, the value of the rules as tools for insuring the fair and efficient operation of the securities markets must outweigh the harm from lack of notice caused by the indefiniteness of the rules.

Applying the vagueness analysis to test the facial validity¹⁰⁴ of Rule 10b-5 as a criminal insider trading provision involves more than a sterile application of void-for-vagueness jargon. The classic language of the due process void-for-vagueness analysis is merely a catalogue of where the Court has been in the past, rather than a prediction of where it will go in the future. The traditional language of due process and the common law canons of statutory construction are axioms of experience rather than rules of law,¹⁰⁵ and therefore can be invoked as support only

member of any gang consisting of two or more persons, and who had been convicted of any crime. *Id.* at 452. The meaning of the word "gang" was held "so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application." *Id.* at 453.

¹⁰⁰ *United States v. Petrillo*, 332 U.S. 1, 7 (1947). *Petrillo* involved the constitutionality of a criminal conviction under the Lea Act which made it a crime to compel a broadcaster to employ persons in excess of the number that broadcaster actually needed. The Court upheld the validity of the statute, arguing that the standard embodied as much exactness as the subject matter permitted. See Note, *Due Process Requirements of Definiteness in Statutes*, *supra* note 85, at 82-83.

¹⁰¹ See *United States v. Petrillo*, 332 U.S. 1 ("the Constitution does not require impossible standards"). See also text accompanying note 100 *supra*.

¹⁰² See Note, *Due Process Requirements of Definiteness in Statutes*, *supra* note 85, at 83 (citing *United States v. Petrillo*, 332 U.S. 1; *Miller v. Strahl*, 231 U.S. 426, 434; 1915 *Baltimore & Ohio R.R. v. ICC*, 221 U.S. 612, 620 (1911)).

¹⁰³ See *United States v. Charnay*, 537 F.2d at 355 (Sneed, J., concurring). See also Kadish, *supra* note 3, at 440-41.

¹⁰⁴ Here, the use of the term "facial validity" does not mean that the validity of the Rule as written is being tested. Rather, the test is one of the validity of the evolutionary court construction of it as a rule to proscribe insider trading. Cf. Note, *The Void-for-Vagueness Doctrine and the Supreme Court*, *supra* note 88, at 109 n.224 (multiple meanings assigned to the language "attacking a statute on its face").

¹⁰⁵ See Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527, 544 (1947).

after the appropriate balancing of policy considerations has taken place. Rule 10b-5 became a prohibition of insider trading through judicial expansion in civil cases where courts, relying on the remedial nature of the Securities Exchange Act, attached broad meaning to the language of the Rule. Whether these broad civil interpretations, when applied in criminal 10b-5 prosecutions, violate the dictates of due process, is a question left unanswered by the traditional rhetoric. The search for an answer and the proper analysis of policy considerations must begin by turning to the handful of cases that have discussed the due process issue of notice presented by a criminal prosecution under Rule 10b-5.

III. THE COURTS AND 10b-5: ANSWERING THE VOID-FOR-VAGUENESS PROBLEM

*United States v. Charnay*¹⁰⁶ addressed the due process issue of notice in the context of a criminal 10b-5 action. *Charnay* involved manipulation and fraud associated with a corporate takeover bid,¹⁰⁷ rather than insider trading. Finding this conduct proscribed by Rule 10b-5, the Ninth Circuit substantially relied on civil cases¹⁰⁸ holding manipulative activity violative of Rule 10b-5.¹⁰⁹ While the court recognized the potential difficulty presented by the fact that "much of the case law on Rule 10b-5 has . . . developed in civil rather than criminal litigation,"¹¹⁰ it went

¹⁰⁶ 537 F.2d 341.

¹⁰⁷ *Charnay* involved the conduct of Howard Hughes and his associates in the Hughes Tool Company in the takeover of Air West, a Delaware corporation whose stock was listed and traded on the American Stock Exchange. The defendant officials of Hughes Tool made an offer on behalf of their corporation to acquire the assets of Air West at a price which would yield \$22 per share to Air West stockholders. On the day the takeover bid was approved by a majority of the Air West stockholders, a majority of the Air West directors voted to reject the offer. The government alleged in its indictment that the defendants threatened to file law suits and threatened to dump large blocks of Air West stock on the market to artificially depress its price in order to coerce the directors to change their votes. Apparently, these manipulative activities did cause a decline in Air West stock from \$18 per share to \$15.75 per share, in turn causing Air West's directors to reverse their position and accept the offer of Hughes Tool. *Id.* at 344.

The indictment charged wilful violations of 10b-5 in that the

defendants wilfully and knowingly employed a scheme to defraud, made untrue statements of material facts and omitted material facts necessary to make the statements not misleading, and used instruments of interstate commerce to accomplish their scheme, . . . all of which operated as a fraud and deceit upon the purchasers and sellers of Air West stock.

Id. at 345. This indictment was dismissed by the district court, which stated, with regard to the alleged violations of Rule 10b-5, that the Rule is an antifraud provision and "does not purport to define manipulative activity." *Id.* at 346. The court of appeals reversed.

¹⁰⁸ The civil cases cited by the court include: *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 378-81 (2d Cir. 1974); *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 792-98 (2d Cir. 1969); *Mutual Shares Corp. v. Genesco, Inc.*, 384 F.2d 540, 546-47 (2d Cir. 1967).

¹⁰⁹ 537 F.2d at 348.

¹¹⁰ *Id.* at 345.

on to hold that "precedents established in civil cases interpreting Rule 10b-5 are applicable in criminal prosecutions under the rule."¹¹¹ Despite its recognition that there were "no cases at all involving the specific conduct in which the (defendants) . . . are alleged to have engaged,"¹¹² and that "none of the factual situations in the cases discussed . . . are

¹¹¹ *Id.* In ruling that civil precedents under 10b-5 are applicable in criminal prosecutions, the court first relied on *SEC v. Joiner Corp.*, 320 U.S. at 355, which the court cited for the proposition that "the primary difference between the criminal and civil prosecutions under the securities laws is the burden of proof required for a verdict." 537 F.2d at 348. However, *Joiner* was a civil and not a criminal case, and the Court was simply noting that in a criminal case, the evidence would have to establish beyond a reasonable doubt that nonfractional oil and gas leaseholds are securities under the terms of the Securities Act. See note 31 *supra* and note 129 *infra*, for further discussions of *Joiner*. The Court did not indicate that the "primary" difference between civil and criminal prosecutions under the securities laws is this burden of proof requirement, nor did it establish that a civil precedent was directly applicable in a criminal prosecution under the Act. That *Joiner* cannot be read as broadly as *Charnay* contends is evident from the language in *Joiner* upon which *Charnay* relied:

In the present case we do nothing to the words of the Act; we merely accept them. It would be necessary in any case for any kind of relief to prove that documents being sold were securities under the Act. In some cases it might be done by proving the document itself, which on its face would be a note, a bond, or a share of stock. In others proof must go outside the instrument itself as we do here. Where this proof is offered in a civil action, as here, a preponderance of the evidence will establish the case; if it were offered in a criminal case, it would have to meet the stricter requirement of satisfying the jury beyond a reasonable doubt.

SEC v. Joiner Corp., 320 U.S. at 355.

The *Charnay* court also relied upon *United States v. Clark*, 359 F. Supp. 128 (S.D.N.Y. 1973), to support its argument that civil precedents are equally applicable in criminal 10b-5 prosecutions. The court wrote that "[a]s noted in *United States v. Clark*, 359 F. Supp. 128, 130 (S.D.N.Y. 1973), 'there is no reasonable basis for holding that some different interpretation (of Rule 10b-5) should apply in a criminal action' than in a civil action." 537 F.2d at 348 (parenthetical supplied by court). However, the language taken from *Clark* and relied on by the *Charnay* court does not stand for the general proposition that civil precedents must universally be applied in criminal 10b-5 actions. Again, the court's own language provides the relevant context and illustrates its limited scope:

As a result of *Texas Gulf and Heit* (402 F.2d 909 (2d Cir. 1968)), the Court of Appeals for this Circuit has announced its interpretation of the "in connection with" language of § 10(b) and Rule 10b-5, and has applied that interpretation both in an S.E.C. injunctive action and in private damage actions. In my view, there is no reasonable basis for holding that some different interpretation should apply to a criminal action.

United States v. Clark, 359 F. Supp. at 130.

Thus, *Clark* was merely applying civil precedent to determine the meaning of a specific phrase in section 10(b), eventually adopting a meaning supported not only by previous civil precedent, but also by the legislative history of the Act itself. See *SEC v. Texas Gulf Sulphur*, 401 F.2d at 860 ("[I]t seems clear from the legislative purpose Congress expressed in the Act, and the legislative history of Section 10(b) that Congress when it used the phrase . . . intended only that the device . . . cause reasonable investors to rely thereon . . . and cause them to purchase or sell a corporation's securities."), quoted in *United States v. Clark*, 359 F. Supp. at 129-30. The importance of the language "in connection with" in defining the scope of § 10(b) argues against any analysis which assumes that in adopting civil precedent with respect to this phrase, the *Clark* court was endorsing wholesale use of civil precedents in criminal 10b-5 actions.

¹¹² 537 F.2d at 347.

identical to that present here,"¹¹³ the court relied on these civil cases to uphold the defendants' convictions.¹¹⁴ Thus, without directly confronting it, the *Charnay* court implicitly rejected the notice-due process issue by applying a new standard of conduct, derived exclusively from civil cases, to a criminal prosecution under 10b-5.

While the majority opinion in *Charnay* did not address the notice issue, Judge Sneed raised serious questions as to the propriety of the court's approach to Rule 10b-5 in criminal prosecutions in his concurring opinion.¹¹⁵ Judge Sneed first indicated that, as with statutes defining other "public welfare offenses,"¹¹⁶ neither section 10(b) nor Rule 10b-5 is interpreted narrowly when employed in criminal prosecutions, although criminal statutes are ordinarily interpreted narrowly.¹¹⁷ With regard to the specific facts of *Charnay*, Judge Sneed stated that the court found

an indictable offense charged in the indictment despite the fact that there exists no case, not even one imposing civil liability, in which substantially similar facts have been treated as a violation of Section 10(b) and Rule 10b-5. These provisions have been applied herein to the conduct of defendants no differently than they would have been in a civil action.¹¹⁸

Despite the lack of any direct precedent, including any civil precedent, the court permitted a criminal prosecution for violation of Rule 10b-5. Such an approach, contrary to traditional vagueness analysis, is permitted in the unique context of Rule 10b-5, as Judge Sneed indicates:

(I)n fixing criminal liability under section 10b-5, we attach reduced importance to assertions of vagueness. The fact that men of common intelligence—or lawyers and judges for that matter—"must necessarily guess at its meaning and differ as to its application," does not require that we declare this section 10(b) void for vagueness.¹¹⁹

Rather than responding to the demands of due process for clear criminal statutes, the courts, in applying section 10(b) and Rule 10b-5 in criminal cases,

respond to stern and demanding fatalism reflected in *Nash v. United States*

. . . :

¹¹³ *Id.* at 349.

¹¹⁴ See cases cited in note 108 *supra*.

¹¹⁵ 537 F.2d at 355 (Sneed, J., concurring).

¹¹⁶ See Sayre, *Public Welfare Offenses*, 33 COLUM. L. REV. 55 (1933). Sayre defines public welfare offenses to be the "group of police offenses and criminal nuisances [which are] punishable irrespective of the actor's state of mind . . ." *Id.* at 56 n.5. Examples of such offenses include crimes for the sale of adulterated or impure food and drugs, crimes for the violation of traffic regulations and motor vehicle laws and crimes for the violation of most other police regulations designed to promote the safety, health or morals of the community. *Id.* at 55, 72-73. Most of these offenses are punishable irrespective of the intent of the actor. *Id.* at 55.

¹¹⁷ 537 F.2d at 355-56 (Sneed, J., concurring).

¹¹⁸ *Id.* at 356.

¹¹⁹ *Id.* at 356-57 (footnotes omitted).

"[T]he law is full of instances where a man's fate depends on his estimating rightly, that is as the jury subsequently estimates it, some matter of degree. If his judgment is wrong, not only may he incur a fine or a short imprisonment . . . ; he may incur the penalty of death."¹²⁰

Thus, *Charnay* adopted a policy of ensuring fair and efficient markets¹²¹ which operates to subordinate the traditional vagueness doctrine to the needs of Rule 10b-5. It did so by extending the broad constructions of the securities laws in civil cases to criminal prosecutions under those laws. It is this policy, when applied to support a criminal prosecution under Rule 10b-5, that Judge Sneed finds particularly "disturbing."¹²² Adopting and promoting such a policy in 10b-5 prosecutions vests the court with a residual power to proscribe conduct under the Rule never before found illegal by any court.¹²³

A similar approach to that applied in *Charnay* was adopted in *United States v. Perskey*,¹²⁴ where the defendant contended on appeal that section 10(b) and Rule 10b-5 were unconstitutionally vague. In responding to Perskey's contention that the broad civil interpretations of the Rule had so expanded its scope as to provide insufficient warning of the sorts of fraud proscribed under a standard of strict construction,¹²⁵ the court replied that "[n]o honest and reasonable citizen could have difficulty in understanding the meaning of 'untrue,' 'material fact,' 'any omission to state a material fact,' . . . or 'misleading' . . ."¹²⁶ Despite the court's confidence that any honest citizen knows the meaning of phrases such as "material fact," Professor Bromberg¹²⁷ notes the serious difficulties encountered in determining when information is material and who is a statutory insider.¹²⁸ Yet, despite this difficulty in determining the meaning of materiality in the context of Rule 10b-5, the *Perskey* court did not strictly construe the Rule in the criminal prosecution.¹²⁹ The court

¹²⁰ *Id.* at 357 (quoting *Nash v. United States*, 229 U.S. 373, 377 (1913)).

¹²¹ 537 F.2d at 356.

¹²² Despite the traditional deference given to the vagueness doctrine in interpreting and in applying criminal statutes, Judge Sneed accepted this policy and the existing authority granted under 10b-5 to ensure the fair operation of markets even where such acceptance meant ignoring the traditional requirements of the vagueness doctrine, although finding "no satisfaction or pleasure in doing so." *Id.* at 357.

¹²³ *Id.*

¹²⁴ 520 F.2d 283.

¹²⁵ *Id.* at 287.

¹²⁶ *Id.* (quoting *Coplin v. United States*, 88 F.2d 652, 657 (9th Cir.), *cert. denied*, 301 U.S. 703 (1937)).

¹²⁷ See A. BROMBERG, *supra* note 14.

¹²⁸ See notes 67-69 *supra*.

¹²⁹ 520 F.2d at 288. The rejection of a strict construction of the terms of Rule 10b-5 in a criminal prosecution is puzzling given the early treatment accorded the Rule by the Supreme Court in *SEC v. Joiner Corporation*, 320 U.S. 344. In this civil action under Rule 10b-5, the defendants argued that the definition of security under the Securities Act of 1933 fell short of encompassing the particular activity in which they engaged. The defendants argued that the

found, moreover, that Perskey's conduct¹³⁰ would still have been "fraudulent even under the most restrictive definition of 'common law fraud,'"¹³¹ and therefore would be proscribed under a strict reading of Rule 10b-5. The court did not reject the vagueness argument for future 10b-5 cases. It noted that Perskey could not attack Rule 10b-5 on vagueness grounds because other conduct would be more ambiguous under the Rule than Perskey's fraud.¹³²

In a more recent case involving section 17(a) of the Securities Act of 1933, the Court answered a vagueness attack on section 17(a) as it was applied in a criminal prosecution for fraud in the sale of securities. In *United States v. Naftalin*,¹³³ the defendant Naftalin ordered various brokers to sell shares which he did not own, hoping that the price of the shares would fall before delivery.¹³⁴ While the Eighth Circuit found

definition of security must be strictly construed as they were subject to potential criminal liability under section 32(a) of the Act. The Court rejected this argument, stating in dicta that:

though penal laws are to be construed strictly, they are not to be construed so strictly as to defeat the obvious intention of the legislature. The maxim is not to be so applied as to narrow the words of the statute to the exclusion of cases which those words, in their ordinary acceptation, or in that sense in which the legislature has obviously used them, would comprehend.

Id. at 354 (quoting *United States v. Wiltberger*, 5 Wheat. 76, 95 (1820)). The Court in *Joiner* also found persuasive the fact that this was a civil case, not a criminal case, and whereas in the civil action a preponderance of the evidence will establish that the transaction in question involved a "security," the proof, if offered in a criminal case, would have to meet the stricter requirement of establishing beyond a reasonable doubt that the transaction did involve a security. *Id.* at 355. The higher degree of proof which would be required to prove that a particular act involved a security permitted the Court, in this civil action, to adopt an interpretation of the meaning of "security" which went beyond statutory language. The interpretation was not created, however, in the criminal context, and the Court implies that such post-hoc broadening of the statute would not have been permitted in the review of a criminal conviction for the same conduct. The *Joiner* Court's willingness to distinguish between the scope of Rule 10b-5 in civil actions and the scope of the same rule in criminal prosecutions has not been accepted by other courts, including *Perskey*, in their treatment of similar problems.

¹³⁰ Perskey, a securities lawyer, was convicted for violation of Rule 10b-5 in connection with a series of false press releases issued and false statements made to stockholders of a corporation of which Perskey was an officer. Through a series of speculative transfers, the company's president, Kaplan, squandered some \$375,000 of the corporation's assets. To cover this indiscretion, Perskey proposed to arrange a merger whereby the corporation's assets and liabilities would be assumed by the merger candidate. Toward this end, Perskey issued a press release describing the proposed merger, misrepresenting in that release the existence of the \$375,000 as residual assets of the corporation. To obtain stockholder approval of the scheme, Perskey issued statements describing the proposed action without disclosing the fact that the \$375,000 represented as assets did not exist.

¹³¹ 520 F.2d at 287-88.

¹³² *Id.* at 288.

¹³³ 441 U.S. 768 (1979) (8-0 decision).

¹³⁴ This scheme would have allowed Naftalin to purchase shares at the now lower market price to cover his sell orders, thus reaping in profit the difference between his purchase price and the price he "sold" the shares for when he placed the sell orders with brokers. Unfortu-

that the evidence established fraud on the part of Naftalin in the conduct of these transactions, it vacated his conviction and held that section 17(a)(1) applies only to frauds injuring investors, not to those injuring only brokers.¹³⁵ The Supreme Court reversed, in an 8-0 decision, finding that Congress plainly intended section 17(a)(1) to apply to brokers as well as to investors. The Court did not find persuasive the argument that in this criminal case, a stricter standard must be applied to Naftalin's benefit:

This is a criminal case, and we have long held that "ambiguity concerning the ambit of criminal statutes should be resolved in favor of lenity," . . . , and that a defendant may not "be subjected to a penalty unless the words of the statute plainly impose it." . . . In this case, however, the words of the statute do "plainly impose it." Here, "Congress has conveyed its purpose clearly, and we decline to manufacture ambiguity where none exists,"¹³⁶

It should be noted however, that this was not a close case, as Naftalin admitted that he had defrauded the brokers who executed his sales by falsely representing that he owned the stock he "sold."¹³⁷

Finally, in a similar action involving fraud in the sale of stock which was prosecuted under Rule 10b-5, the Third Circuit held that the Rule need not be applied more narrowly in a criminal 10b-5 prosecution than it was applied in a civil action. In *United States v. Peltz*,¹³⁸ defendant Peltz was charged with violations of Rule 10b-5 for allegedly entering sell orders with brokers for stock which he falsely claimed to own. Again, the *Peltz* court favored the policy of insuring the fair and efficient operation of security markets over the policy that criminal statutes should be construed narrowly in favor of the accused, or at least construed more narrowly than civil incarnations of the same statute.

The Second Circuit provided an answer to the vagueness attack on Rule 10b-5 in the specific context of a criminal prosecution for insider trading in *United States v. Chiarella*.¹³⁹ This court, affirming the criminal conviction of a financial printer for violation of Rule 10b-5, bluntly rejected the void-for-vagueness argument. In doing so, it held that under Rule 10b-5, "[a]nyone—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose."¹⁴⁰

nately for Naftalin, the market price of the shares he "sold" did not drop but in fact rose sharply, leaving him unable to make covering purchases, and forcing the brokers to borrow stock to keep their delivery promises.

¹³⁵ 441 U.S. at 771.

¹³⁶ *Id.* at 778-79 (citations omitted).

¹³⁷ *Id.* at 772.

¹³⁸ 433 F.2d 48 (2d Cir. 1970).

¹³⁹ 588 F.2d 1358 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).

¹⁴⁰ *Id.* at 1365.

This broad statement of liability under 10b-5 for insider trading grew out of facts which plainly evidenced chicanery of one form or another.¹⁴¹ The court of appeals seized on this chicanery to create its broad standard of liability for trading on material nonpublic information without prior disclosure.¹⁴² The Second Circuit was unpersuaded by Chiarella's argument that imposition of a Rule 10b-5 duty to disclose on one other than a traditional corporate insider was "so novel a construction of the Rule as to violate the fair notice element of due process."¹⁴³ "That no prior litigated case has involved the precise fact pattern at issue"¹⁴⁴ was not dispositive as long as "a clear and definite statement of the conduct proscribed"¹⁴⁵ antedates the criminal act. The court found this clear and definite statement in two ways. First, the court relied on a civil action brought by the Commission in 1974, enjoining various employees of Sorg Printing Co. from trading on information revealed through their employment activities.¹⁴⁶ Second, the court relied upon signs posted by Chiarella's employer throughout the work-

¹⁴¹ Chiarella worked in the composing room of the New York office of a financial printer. In the course of his duties, which involved the selection of type fonts and page layouts, Chiarella handled the raw material for the announcement of five corporate takeover bids. To preserve the confidentiality of the corporations involved in the bids, the identities of the acquiring and target corporations were concealed in the copy sent to the printer through the use of blank spaces or false names. During the final press run, on the night before release of the takeover bid, the true names were inserted. Chiarella, "no ordinary printer, but a knowledgeable stock trader who spoke with his broker as many as ten or fifteen times a day," *id.* at 1363, was able to draw on other information contained in the documents to deduce, prior to the date of this final printing, the names of the target corporations. Knowing the identity of the targets, Chiarella would purchase shares in the target companies and then sell quickly after announcement of the takeover bid, reaping substantial profits. These profits amounted to over \$30,000 in the course of some 14 months and 5 takeover bids. The Commission instituted an investigation of Chiarella's activities, which eventually resulted in the criminal indictment of Chiarella on 17 counts of violating § 10(b) and Rule 10b-5. These facts are set out in detail at 588 F.2d at 1363-64 and 445 U.S. 222 at 224-25.

¹⁴² 588 F.2d at 1363.

¹⁴³ *Id.* at 1369.

¹⁴⁴ *Id.*

¹⁴⁵ *Id.* (quoting *United States v. Perskey*, 520 F.2d 283, 288 (2d Cir., 1975)).

¹⁴⁶ *SEC v. Sorg Printing Co.*, [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,034 (S.D.N.Y. March 28, 1975). The conduct of the individual defendants in this action, who were employees of Sorg, another financial printer, was conduct identical to that of Chiarella. The individual defendants in this civil action consented to the entry of a preliminary injunction to prevent further trading in the shares of tender offerees by Sorg employees, thus limiting the precedential value of this proceeding. Chiarella was the first individual prosecuted under Rule 10b-5 for his conduct. After *Sorg*, only civil proceedings had been brought against similarly situated printers who engaged in conduct almost identical to that of Chiarella. *See SEC v. Mandarano* [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,357 (D.N.J. March 22, 1978) (defendants consented to entry of final judgment and permanent injunctions, as well as disgorging profits derived from their activity); *SEC v. Primar Typographers, Inc.* [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 90,734 (S.D.N.Y. 1976) (defendants consented to the entry of final judgment and permanent injunctions, without admitting or denying the allegations set out in the complaint); *SEC v. Ayoub* [1975-76 Transfer Binder]

place which notified employees that trading on information contained in customers' copy could violate the securities laws and subject them to criminal penalties.¹⁴⁷ These signs provided "explicit warning of the consequences of . . . [Chiarella's] conduct."¹⁴⁸ The court found that these signs provided a high degree of notice, particularly because Chiarella "admitted passing the sign at least 640 times."¹⁴⁹

In a dissenting opinion,¹⁵⁰ Judge Meskill accepted Chiarella's notice argument, particularly in light of the inability of the above two factors to provide the degree of notice traditionally demanded of *criminal* statutes. Judge Meskill noted that the court's application of 10b-5 to the conduct in question was a clear expansion of prior law,¹⁵¹ since the majority had created a new category of market insider. Insiders now included persons who were without a special relationship to a company and were not privy to its internal affairs.¹⁵² These persons had previ-

FED. SEC. L. REP. (CCH) ¶ 95,567 (S.D.N.Y. 1976) (complaint only, SEC seeking a preliminary injunction).

Although the four cases cited above involve activity identical in most respects to that of Chiarella, they are all civil cases and were all settled by the entry of consent decrees or preliminary injunctions. These factors did not deter the Second Circuit from citing them in support of its notice analysis. *See* *United States v. Chiarella*, 588 F.2d 1358, 1369 n.17 (2d Cir. 1978).

¹⁴⁷ The 8" x 10" signs, posted by Chiarella's employer, read as follows:

TO ALL EMPLOYEES:

The information contained in all type set and printing done by Pandick Press, Inc., is the private and personal property of the customer.

You are forbidden to use any information learned from customer's copy, proofs or printed jobs for your own or anyone else's benefits, friend or family or talking about it except to give or receive instructions. Any violation of this rule will result in your being fired immediately and without warning.

In addition, you are liable to criminal penalties of 5 years in jail and \$10,000 fine for each offense.

If you see or hear of anybody violating this, report it immediately to your supervisor or to Mr. Green or Mr. Fertig. Failure to report violations will result in your being fired. 588 F.2d at 1369.

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.* at 1373 (Meskill, J., dissenting).

¹⁵¹ *Id.* The law prior to the *Chiarella* case specifically rejected the imposition of liability on such nontraditional insiders, according to Meskill:

In *General Time Corp. v. Talley Industries, Inc.*, . . . , this court rejected a claim that a company acquiring stock in another corporation must disclose to selling shareholders plans for an eventual merger:

"We know of no rule of law, applicable at the time, that a purchaser of stock, who was not an "insider" and had no fiduciary relation to a prospective seller, had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale."

Id. at 1373 (quoting *General Time Corp. v. Talley Industries, Inc.*, 403 F.2d 159, 164 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969)).

¹⁵² The dissent quoted from Cady, Roberts & Co., 40 S.E.C. at 912, which defined the central task established by 10b-5 to be the identification of "those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading its securities." 588 F.2d at 1374 (Meskill, J., dissenting) (emphasis in original deleted).

ously been under no duty to disclose information to the sellers of stock.¹⁵³ The majority's broad reading of Rule 10b-5 did not provide a "clear and definite statement of the conduct proscribed" prior to the actions alleged to be criminal.¹⁵⁴ Adopting the traditional notice-due process analysis, Judge Meskill noted that such a "clear and definite statement," in order to pass the notice test, "must emanate from the language of the statute itself, from prior judicial interpretation or from established usage."¹⁵⁵ Thus, warning signs posted by Chiarella's employer were irrelevant to the issue of notice. Such signs could not transform conduct not otherwise proscribed into conduct proscribed by that statute.¹⁵⁶ Since the statutory language of Rule 10b-5 did not proscribe Chiarella's conduct and no precedent extended the Rule to reach such conduct, a sufficiently clear statement prohibiting Chiarella's conduct did not exist which would permit the imposition of the criminal sanction.¹⁵⁷

While Judge Meskill's dissent provided the first rigorous application of the notice-due process doctrine to a prosecution of insider trading under 10b-5, the Supreme Court reversed the court of appeals without explicitly adopting the notice analysis of the dissent. The Court in *Chiarella v. United States*¹⁵⁸ held that a duty to disclose under section 10(b) does not arise from the mere possession of nonpublic information,¹⁵⁹ and therefore, in the absence of such a duty, the Court overturned the conviction of Chiarella.¹⁶⁰ In overturning the conviction,

¹⁵³ 588 F.2d at 1375 (Meskill, J., dissenting).

¹⁵⁴ *Id.* at 1376-77.

¹⁵⁵ *Id.* at 1377.

¹⁵⁶ *Id.* Cf. *Bouie v. City of Columbia*, 378 U.S. 347 (1964) (convictions under trespassing statute held void-for-vagueness). In *Bouie*, the Court rejected a contention that defendants were provided adequate notice of a trespass violation because a chain with a 'no trespassing' sign attached had been placed on the premises by the owner of the restaurant where the alleged violation took place: "[t]he determination whether a criminal statute provides fair warning of its prohibitions must be made on the basis of that statute itself and the other pertinent law, rather than on the basis of an ad hoc appraisal of the subjective expectations of particular defendants." *Id.* at 347-48.

¹⁵⁷ 588 F.2d at 1377 (Meskill, J., dissenting).

¹⁵⁸ 445 U.S. 222.

¹⁵⁹ *Id.* at 235.

¹⁶⁰ The Court reached this conclusion by focusing upon the relationship which has traditionally given rise to this duty to disclose. While noting the broad, remedial nature of § 10(b) and of Rule 10b-5, the Court made clear that the affirmative duty to disclose material information which "has been traditionally imposed on corporate insiders; particular officers, directors or controlling stockholders," *id.* at 227 (quoting *Cady Roberts & Co.*, 40 S.E.C. at 911), arises from "(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure." *Id.* While such an obligation to disclose as between a corporate insider and the stockholders of his corporation is not novel, noted the Court, one who fails to disclose material information prior to the sale or purchase of securities commits fraud only when he is under a *duty* to disclose. *Id.* Such

however, the Court made clear that it was not deciding (1) whether Chiarella breached a duty to the acquiring corporation by virtue of his position as an employee of the printer doing the printing for that corporation, (2) whether such a duty exists, and (3) whether such a breach might constitute a violation of section 10(b) or Rule 10b-5.¹⁶¹ By concluding its opinion with this caveat,¹⁶² the possibility is left open for criminal proceedings against nontraditional insiders such as Chiarella where a duty to an entity or to a person other than the seller of securities is alleged in the indictment.

While this series of cases illustrates the willingness of the federal courts to reject due process attacks in the context of Rule 10b-5 criminal prosecutions, it does little to illuminate precisely why the rule, in its broadest application, should be impervious to constitutional challenge. While *Charmay* stands for the proposition that precedents established on

a duty arises only where one party has information the other is entitled to prior to entering the transaction because of a fiduciary or similar confidential relationship running between the two. *Id.* Although the Court did accept the broad judicial and administrative interpretations of Rule 10b-5 creating liability for insider trading, it emphasized that such liability is contingent upon a duty to disclose arising out of a relationship of trust between the parties involved in the transaction:

[A]dministrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b) despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure. But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction. Application of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place shareholders' welfare before their own, will not benefit personally through fraudulent use of material nonpublic information.

Id. In the instant case, because Chiarella was neither a corporate insider nor a recipient of confidential information of the target company, the Court could not find such a duty "without recognizing a general duty between all participants in market transactions to forego actions based on material, nonpublic information." *Id.* at 233. Unwilling to adopt such a broad duty in the face of traditional doctrine that a duty to disclose arises out of a specific relationship between the two parties, the Court reversed. *Id.*

¹⁶¹ *Id.* at 235-37.

¹⁶² Despite this caveat, the Court does adopt language which is reminiscent of that of a notice-due process analysis without explicitly using that label:

[T]he 1934 Act cannot be read "more broadly than its language and the statutory scheme reasonably permit." . . . Section 10(b) is aptly described as a catch-all provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information. The contrary result is without support in the legislative history of § 10(b) and would be inconsistent with the careful plan that Congress has enacted for regulation of the securities markets.

Id. at 234-35 (citations omitted).

Additionally, a judicial holding that certain undefined activities "generally are prohibited by § 10(b) would raise questions whether either criminal or civil defendants would be given fair notice that they have engaged in illegal activity. . . .

It is worth noting that this is apparently the first case in which criminal liability has been imposed upon a purchaser for § 10(b) nondisclosure.

Id. at 235 n.20 (citations omitted).

the civil side of Rule 10b-5 are equally applicable in criminal prosecutions under the Rule, it does not explain why these precedents should be equally applicable. *Perskey* stands for the proposition that plainly fraudulent activity can be reached, even in a criminal prosecution, by a statute that might be subject to vagueness attacks in less compelling cases. Yet, the factors which determine when the fraud is so compelling that it overrides constitutional concerns of due process are left for other courts to define. While the Supreme Court in *Chiarella* refused to permit the criminal conviction of a nontraditional insider for his violation of Rule 10b-5's proscription against insider trading, the Court, in choosing not to reach the constitutional question, left intact the traditional view of section 10(b) and Rule 10b-5 as broad, remedial provisions capable of proscribing insider trading in both the civil and criminal contexts. Because none of the cases discussed above actually reaches the question of when the concern for fair and efficient securities markets requires that constitutional notions of due process be disregarded in criminal prosecutions of insider trading under Rule 10b-5, the remaining two sections of this comment formally balance the philosophy of due process and the concept of notice in criminal cases with the concern for fair and efficient securities markets. This analysis will illustrate why, given the philosophy of due process and given the policy arguments in favor of more definite proscriptions of insider trading, the use of Rule 10b-5 in criminal prosecutions of insider trading should cease.¹⁶³

IV. THE *SHAW* ANALOGY AND THE PHILOSOPHY OF DUE PROCESS

Section 10(b) and Rule 10b-5 are traditionally viewed as broad, remedial provisions whose breadth permits the courts, without prior criminal precedent, "to find an indictable offense when it is necessary to do so 'to insure the maintenance of fair and honest markets.'"¹⁶⁴ A

¹⁶³ Subsequent to the decision in *Chiarella*, the SEC adopted Rule 14e-3 to deal with "insider" trading in the context of a tender offer, and to fill the gap in the law left by *Chiarella*. See SEC Securities Act Release No. 6239 (Sept. 4, 1980) [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,646. The rule, in its basic substantive provisions, requires a person who possesses nonpublic information relating to a tender offer either to disclose that information prior to purchase or sale of any relevant securities or to abstain from trading entirely. See 45 Fed. Reg. 60,410 (to be codified in 17 C.F.R. 240.14e-3). The provision took effect October 14, 1980. While a step in the direction of definiteness in the context of insider trading during the course of a tender offer, the provision does nothing to deal with insider trading in the context of the ordinary purchase and sale. Such conduct is still subject to the vague proscription of Rule 10b-5. Presumably, the SEC might still bring a prosecution for insider trading in the context of a tender offer under Rule 10b-5 when the provisions of Rule 14e-3 prove too rigid to encompass a particular violation. Rule 14e-3, then, has merely supplemented, not supplanted, the provisions of Rule 10b-5. See generally Note, *Trading on Material, Nonpublic Information Under Rule 14e-3*, 49 GEO. WASH. L. REV. 539 (1981).

¹⁶⁴ *United States v. Charnay*, 537 F.2d at 356.

striking similarity exists between this traditional view of section 10(b) and Rule 10b-5 and the approach taken in the English case of *Shaw v. Director of Public Prosecutions*¹⁶⁵ in order to find an indictable offense when necessary to protect public morals. Both the approach taken in *Shaw* and the view adopted by the courts of section 10(b) and Rule 10b-5 amount to an assertion of a residual power to use vague policy concerns to justify the proscription of conduct never before reached by the criminal law.¹⁶⁶ Assessing the flaws inherent in the *Shaw* approach and comparing that approach with that adopted in criminal prosecutions under 10b-5 will demonstrate the inconsistency between the philosophy of due process and the practical application of Rule 10b-5 as a criminal insider trading provision as well as show the blatant unconstitutionality of such an application of the rule.

Shaw was charged with the crime of conspiring to corrupt the public morals by his publication of a booklet entitled the "Ladies Directory." The directory was a list of names and addresses of local female prostitutes, who had paid Shaw for the inclusion of their names in the booklet. Shaw was convicted by a jury in the Central Criminal Court following a charge by the judge that a conspiracy to corrupt the public morals was a common law misdemeanor. The House of Lords sustained the conviction. Both Viscount Simonds and Lord Tucker, writing for the majority, concluded that the absence of exact precedent did not bar a conviction for conspiracy to corrupt public morals.¹⁶⁷ The lower appeals court, the Court of Criminal Appeal, had drawn a distinction between creating a new offense and "applying existing law to new facts,"¹⁶⁸ and argued that, in convicting Shaw, the trial court was doing the latter rather than creating new law.¹⁶⁹ Viscount Simonds did not explicitly adopt this distinction; rather, he spoke of a residual power in the courts to create new offenses where necessary to protect public morals:

¹⁶⁵ [1961] 2 All E.R. 446.

¹⁶⁶ This comparison between the approach taken in *Shaw* and that taken with regard to Rule 10b-5 was suggested by Judge Sneed in his concurring opinion in *United States v. Charnay*, 537 F.2d at 356 (Sneed, J., concurring) (footnote omitted):

The resemblance from an analytic viewpoint between our approach and that employed in *Shaw v. Director of Public Prosecutions*, 2 A.E.R. 452 [sic.] (1961), where the House of Lords recognized that the common law crime of corrupting public morals requires a residual power to proscribe unanticipated wickedness *contra bonos mores*, strikes me as disturbingly close. To protect and preserve honest markets we assert the residual power derived from a broad statute and rule to proscribe conduct surrounding a corporate takeover never here to fore branded improper by judicial decision, Commission rule or determination, or explicit Congressional act.

¹⁶⁷ See Brownlie & Williams, *Judicial Legislation in Criminal Law*, 42 CAN. BAR. REV. 561, 596 (1964).

¹⁶⁸ *R. v. Shaw*, [1961] 1 All E.R. 330, 338 (Crim. App.).

¹⁶⁹ *Id.*

In the sphere of criminal law . . . , there remains in the courts of law a residual power . . . to conserve not only the safety and order but also the moral welfare of the state, and it is their duty to guard it against attacks which may be the more insidious because they are novel and unprepared for. . . . (T)here is . . . a residual power, where no statute has yet intervened to supersede the common law, to superintend those offences which are prejudicial to the public welfare.¹⁷⁰

Thus, the *Shaw* court asserted a power, originally wielded by the Star Chamber,¹⁷¹ which enabled it to proscribe any activity prejudicial to the public welfare, even where no statute or continued common law practice proscribed such conduct.

In his dissent, Lord Reid criticized this broad view of the authority of the court to proscribe conduct under its power as *custos morum*. He argued that convicting Shaw for conspiring to corrupt public morals amounted to the imposition of a criminal penalty for conduct which prior to Shaw's acts had not been a crime.¹⁷² Thus, conduct not criminal on previous authority became so simply by judicial fiat. While such a power to create new criminal offenses may have been beneficial in the days when Parliament seldom met, Lord Reid concluded that today it is the province of the legislature and not of the judiciary to create new offenses.¹⁷³ Lord Reid noted¹⁷⁴ that permitting a court to create new criminal offenses deprives the individual of the right to notice and, thus,

¹⁷⁰ [1961] 2 All E.R. 446, 452 (Viscount Simonds).

¹⁷¹ See Brownlie & Williams, *supra* note 167, at 567.

¹⁷² Lord Reid wrote:

[I]n order to extend this offence [conspiracy] to a new field, the court would have to create a new unlawful act; it would have to hold that conduct of a kind which has not hitherto been unlawful in this sense must now be held to be unlawful. It appears to me that the objections to that are just as powerful as the objections to creating a new offence. The difference is a matter of words; the essence of the matter is that a type of conduct for the punishment of which there is no previous authority now for the first time becomes punishable solely by a decision of a court.

[1961] 2 All E.R. 446, 453 (Lord Reid, dissenting).

¹⁷³ *Id.* (quoting *R. v. Newland*, [1953] 2 All E.R. 1067, 1072-73).

¹⁷⁴ Lord Reid argues that:

[i]t has always been thought to be of primary importance that our law, and particularly our criminal law, should be certain; that a man should be able to know what conduct is and what is not criminal, particularly when heavy penalties are involved. Some suggestion was made that it does not matter if this offence is very wide; no one would ever prosecute and if they did no jury would ever convict if the breach was venial. . . . In other words, you cannot tell what is criminal except by guessing what view a jury will take, and juries' views may vary and change with the passing of time. . . . If the trial judge's charge in the present case was right, if a jury is entitled to water down the strong words "deprave," "corrupt" or "debauch" so as merely to mean lead astray morally, then it seems to me that the court has transferred to the jury the whole of its functions as censor morum, and this branch of the law will have lost all the certainty which we rightly prize in other branches of our law.

Id. at 460-61.

of his ability to use the law as a guide for future conduct.¹⁷⁵

Under section 10(b) and Rule 10b-5, any conduct is punishable if it interferes with the maintenance of fair and honest markets and can be classified as a manipulative activity or as a deceptive device. Thus, the concept of "fair and honest markets" in the Securities Exchange Act is the functional equivalent of the concept of "*custos morum*" as employed in *Shaw* to create a crime where none previously existed.¹⁷⁶ The language of section 10(b) and Rule 10b-5 does not proscribe insider trading, but expansive judicial and administrative determinations in civil cases¹⁷⁷ which extend 10b-5 liability to reach insider trading have made that activity a crime. The Second Circuit opinion in *Chiarella* demonstrates how this approach totally disregards the fundamentals of notice and due process. Despite the lack of any civil or criminal precedent imposing liability under Rule 10b-5 on a purchaser in *Chiarella's* position, the court found the imposition of criminal liability consistent with the policy of ensuring a "fair and honest" securities market. The extent to which the court relied on this broad policy to impose 10b-5 liability upon *Chiarella* is evident in the first three sentences of the opinion:

The draftsmen of our nation's securities laws, rejecting the philosophy of *caveat emptor*, created a system providing equal access to the information necessary for reasoned and intelligent investment decisions. It is apodictic that betting on a "sure thing" is anathema to the ideal of "fair and honest markets" established as the foundation of this statutory edifice. *The present case requires us to apply these principles in the context of a criminal prosecution for trading on advance knowledge of stock market events.*¹⁷⁸

Under this approach, a court may convict for the crime of "insider trading," even where previously unproscribed, if it finds that such trading is "anathema to the ideal of fair and honest markets." Still intact after *Chiarella* is the philosophy that expansive holdings in the context of civil

¹⁷⁵ Further criticism of the majority's approach in *Shaw* came from H.L.A. Hart, who discussed the rejection of the concept of fair notice:

The judges [in *Shaw*] seemed willing to pay a high price in terms of the sacrifice of other values for the establishment—or re-establishment—of the Courts as *custos morum*. The particular value which they sacrificed is the principle of legality which requires criminal offences to be as precisely defined as possible, so that it can be known with reasonable certainty beforehand what acts are criminal and what are not.

H. HART, LAW, LIBERTY AND MORALITY 12 (1962).

¹⁷⁶ See note 121 *supra*.

¹⁷⁷ As Justice Rehnquist observed:

When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn. Such a growth may be quite consistent with the congressional enactment and the role of the federal judiciary in interpreting it, . . . , but it would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5.

Blue Chip Stamps v. Manor Drug Stores, 41 U.S. 723, 737 (1975).

¹⁷⁸ 588 F.2d at 1362 (footnotes omitted) (emphasis added).

10b-5 cases can be applied in criminal 10b-5 prosecutions when necessary to preserve the operation of fair and honest markets. Such an approach is anathema to the due process concept of notice.

V. EFFICIENCY AND THE PRACTICAL PROBLEMS OF THE CRIMINAL APPROACH TO INSIDER TRADING UNDER RULE 10b-5

While due process demands that criminal sanctions be eliminated from the proscription of insider trading, several arguments illustrating the inefficiency of criminal prosecutions of insider trading under Rule 10b-5 support the same demand. When a provision meets the requirements of notice by specifically proscribing insider trading and reaches conduct that may impair the fair operation of securities markets, it is inefficient to continue to rely on the vague provisions of Rule 10b-5 to proscribe insider trading. The specific provision which satisfies due process and protects efficient securities markets is section 1603 of the ALI's proposed Federal Securities Code.¹⁷⁹ The provision specifically attacks the problem of insider trading and, unlike section 10(b) and Rule 10b-5, does not purport to be a general antifraud provision.¹⁸⁰ The proposed

¹⁷⁹ ALI FED. SECURITIES CODE § 1603 (1980):

INSIDERS' DUTY TO DISCLOSE WHEN TRADING

SEC. 1603. (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) the identity of the other party to the transaction (or his agent) is known to the insider and (A) the insider reasonably believes that that party (or his agent) knows the fact, or (B) that party (or his agent) knows the fact from the insider or otherwise.

(b) INSIDER.—For purposes of section 1603, "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 who, by virtue of his relationship or former relationship to the issuer, knows a fact of special significance about the issuer or the security in question that is not generally available, or (4) a person who learns such a fact from a person within section 1603(b) (including a person within 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 the purposes of this Code (including the deterrent effect of liability), to treat the person within section 1603(b)(4) as if he were within section 1603(b)(1), (2), or (3).

Id.

¹⁸⁰ Section 1603 deals specifically with insider trading. Fraud and misrepresentation as encountered in its more conventional forms in securities transactions is proscribed by section 1602(a)(1). Section 1602(a)(1) provides that "(i)t 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" ALI FED. SECURITIES CODE § 1602(a)(1) (1980). The proposed code thus recognized the inherent problems of proscribing specific conduct, insider trading, in the context of a general statute designed to reach more conventional fraud in the purchase or sale of securities. The recognition of these problems has to date eluded the courts and the SEC as they continue to use the general anti-fraud provisions of section 10(b) and Rule 10b-5 to reach insider trading.

statute provides, subject to limited exceptions,¹⁸¹ that "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. . . ."¹⁸² After this substantive proscription of insider trading, the statute explicitly defines what constitutes an "insider" for purposes of the proscription.¹⁸³ This definition does not include "quasi-insiders" with no relationship to the issuer, such as the printer in *Chiarella v. United States*,¹⁸⁴ because the drafters of the statute recognized the inherent notice problems presented by including all potential quasi-insiders.¹⁸⁵ The drafters noted that "quasi-insiders" constitute a category of traders that inherently "does not lend itself to definition."¹⁸⁶ The drafters solved the definitional problem by restricting section 1603 to quasi-insiders who have or previously have had a relationship to the issuer,¹⁸⁷ leaving the general antifraud provision of section 1602(a)(1) to reach egregious conduct that does not lend itself to the traditional insider analysis of section 1602.¹⁸⁸ Given the specificity of this proposed statute, the absence of any vagueness or notice problems, and its ability to proscribe all forms of deception that can fairly be labeled as insider trading, it is not surprising that even the SEC has recommended adoption of the statute by Congress.¹⁸⁹

¹⁸¹ *Id.* § 1603(a)(1), (2). Essentially, the rule imposes liability unless the insider reasonably believes that the significant fact has been disclosed, either to the public in general or to his specific trading partner.

¹⁸² *Id.* § 1603(a).

¹⁸³ *Id.* § 1603(b).

¹⁸⁴ 445 U.S. 222 (1980).

¹⁸⁵ See ALI FED. SECURITIES CODE 663 (1980) (Comment (3)(d)).

¹⁸⁶ *Id.* The drafters note the following:

It would be convenient to have a new category of "quasi-insider" that would cover people like (i) judges' clerks who trade on information in unpublished opinions, (ii) Federal Reserve Bank employees who trade with knowledge of an imminent change in the margin rate. . . .

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? In *Chiarella* the court recognized that X13(d) had been construed to permit a would-be tender offeror to buy up to five percent of its prospective target with no disclosure at all. But what about his "tippee"—perhaps his depository bank?

Id.

¹⁸⁷ *Id.* § 1603(b)(3).

¹⁸⁸ *Id.* § 1602(a)(1). The drafters explain that "to the extent that a sufficiently egregious or shocking or offensive 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.'" *Id.* at 663 (comment 3(d)).

¹⁸⁹ SEC Securities Act Releases No. 6242 (Sept. 18, 1980), [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,655. The Commission recommended adoption of the entire Federal Securities Code with only minor revisions. In arguing for the adoption of the proposed code, the Commission recognized the lack of predictability and certainty of the current law: "enactments of this proposal would, on the whole, promote greater predictability and certainty

Rule 10b-5's inherent inability to provide adequate notice leads to the deterrence of legitimate trading activities. Such overdeterrence casts doubt on the efficiency of the rule to protect the fair operation of securities markets. In an environment of indeterminate liability created by vague standards, business activity may not be conducted at all if the expected liability is sufficiently great to deter any activity.¹⁹⁰ Therefore, in establishing a vague standard, regulators run the risk of deterring not only the conduct intended to be proscribed, but also of deterring legitimate business activity. This effect is particularly visible in the modern business environment where a fine line often exists between aggressive but legitimate business activity and activity that is illegitimate.¹⁹¹ Serious attempts to comply with the rule laid down by a vague regulatory scheme might actually result in the curtailment of activity which in economic terms is desirable and necessary for the efficient operation of the securities markets. This problem is particularly acute where the fear of criminal prosecution is an effective deterrent to crime,¹⁹² because the fear such sanctions generate deters legitimate activity.¹⁹³

in the interpretation of the federal securities laws and would, thus, promote investor protection, the integrity of our Nation's securities markets, and the capital formation process." *Id.* Little is left to be said for Rule 10b-5 in the context of prosecutions for insider trading when, as the SEC itself notes, the same goals of protection of the investor and protection of the securities markets can be met by a more certain, and certainly constitutional, statute.

¹⁹⁰ Judge Cardozo made the following observation concerning "liability in an indeterminate amount for an indeterminate time to an indeterminate class: (t)he hazards of business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences." 255 N.Y. 170, 179-80, 174 N.E. 441, 444 (1931).

¹⁹¹ As argued by Kadish,

the behavior under discussion involves restraints upon the free operation of business without at the same time denying commitment to a free enterprise system. The demarcation of the line between the legitimate, indeed the affirmatively desirable, and illegitimate in business conduct is continually in flux and subject to wide controversy in the community.

Kadish, *Criminal Sanctions for Economic Regulations*, *supra* note 3, at 446.

¹⁹² "[S]evere punishments . . . may be footless in preventing crimes of passion. But when the question is one of urging the great well-meaning public into conduct which happens to be slightly inconvenient, severe punishments in the offing—known to be in the offing—are capable of effect." Bell & Friedman, *The Use of Criminal Sanctions in the Enforcement of Economic Legislation: A Sociological View*, 17 STAN. L. REV. 197, 216 n.64 (1965) (quoting LLEWELLYN, JURISPRUDENCE: REALISM IN THEORY AND PRACTICE 403-04 (1962)).

¹⁹³ The Supreme Court identified the problem in the context of a criminal prosecution for Sherman Act violations. *See United States v. United States Gypsum Co.*, 438 U.S. 422 (1978). The Court noted that:

the behavior proscribed by the Act is often difficult to distinguish from the gray zone of socially acceptable and economically justifiable business conduct. Indeed, the type of conduct charged in the indictment in this case—the exchange of price information among competitors—is illustrative in this regard. The imposition of criminal liability on a corporate official, or for that matter on a corporation directly, for engaging in such conduct which only after the fact is determined to violate the statute because of anti-competitive effects, without inquiring into the intent with which it was undertaken,

This concept of overdeterrence is particularly relevant in the context of 10b-5's proscription of insider trading. Professor Bromberg notes that Rule 10b-5 permits trading on information that either has not yet developed to the level of materiality or has been made public through disclosure.¹⁹⁴ Yet he cautions that "[d]ifficulties in identifying these points, especially the former one [materiality], suggest a good deal of self-restraint by those who want to be sure they steer clear of 10b-5."¹⁹⁵ The Supreme Court, recognizing the potential seriousness of overdeterrence in the realm of economic regulation, has required a higher degree of notice in some regulatory schemes.¹⁹⁶ Unfortunately, it has not done this for Rule 10b-5's proscription of insider trading. Thus, given their potential for deterring legitimate trading activities, criminal penalties for insider trading under Rule 10b-5 are an inefficient and undesirable sanction.

The availability of broad civil liability to deter fraudulent insider trading¹⁹⁷ and the restricted use of the criminal sanction¹⁹⁸ throughout the history of Rule 10b-5¹⁹⁹ makes undesirable the vesting of vast discretion in the Commission to determine when to employ the criminal sanction. The wide array of other sanctions available under the Securities Exchange Act, including private actions, injunctive actions and monetary settlements makes the criminal sanction a last resort which is used selectively, though not with certainty, in the more blatantly fraudulent cases.²⁰⁰ The availability of both civil and criminal sanctions vests a high degree of discretion in the Commission and the Justice Depart-

holds out the distinct possibility of overdeterrence; salutary and procompetitive conduct lying close to the borderline of impermissible conduct might be shunned by businessmen who chose to be excessively cautious in the face of uncertainty regarding possible exposure to criminal punishment for even a good-faith error of judgment.

Id. at 440-41 (footnotes omitted).

¹⁹⁴ 2 A. BROMBERG, *supra* note 14, § 7.4(6)(a), at 178 (1977).

¹⁹⁵ *Id.* Bromberg refers to the difficulty of identifying points of materiality in the context of civil liability. While difficulty in identifying the point of materiality may "suggest a good deal of self restraint" in order to avoid civil liability, there are even greater incentives for one not to trade where the threat of criminal sanctions is present.

¹⁹⁶ See Note, *Due Process Requirements of Definiteness in Statutes*, *supra* note 85, at 86. The note cites *Weeds, Inc. v. United States*, 255 U.S. 109 (1921), and *United States v. L. Cohen Grocery Co.*, 255 U.S. 81 (1921).

¹⁹⁷ Herlands, *supra* note 77, at 196.

¹⁹⁸ The restricted use of the criminal sanction in the context of Rule 10b-5 is due in part to the general difficulties encountered by the prosecution in criminal proceedings. The traditional safeguards of proof beyond a reasonable doubt, trial by jury, and other forms of protection combine to make the process too cumbersome for large-scale enforcement. See Bell & Friedman, *supra* note 182, at 214. ("The criminal sanctions remain as threats—they are "used" in the sense of being authorized, but no longer "used" in the sense of wholesale application to offenders.").

¹⁹⁹ See note 76 *supra*.

²⁰⁰ Herlands, *supra* note 77, at 196-197.

ment,²⁰¹ which must decide whether to prosecute the action on behalf of the Commission.²⁰² Thus, two decisions must be made by two different enforcement authorities. The Commission must first decide whether to proceed with any sanction and then must decide whether to proceed civilly or criminally. If the decision is made to proceed criminally, the Attorney General makes the final decision to prosecute or to drop the proceedings. The vast amounts of discretion²⁰³ exercised in this process mean that "the fate of the violator hinges not only upon the pertinent law, but also upon the individual determination of subjective issues by both administrative and prosecutorial officials."²⁰⁴ This result is graphically illustrated in the *Chiarella* case, where Chiarella was prosecuted for a criminal violation of 10b-5 when his conduct was virtually identical to that which had brought only civil sanctions in previous cases.²⁰⁵ The existence of such vast discretion in the context of a vague statute argues for a more definite and certain statute which would indicate the clear limits of prosecutorial discretion in the context of insider trading.

VI. CONCLUSION

When the three practical problems discussed above are considered in the context of the general theoretical problems of notice, considerable doubt is cast on the validity of the criminal application of Rule 10b-5 to insider trading. Rule 10b-5 developed as an insider trading rule through judicial interpretation and expansion in civil cases. This development limits the ability of the Rule to provide adequate constitutional notice of exactly what behavior is subject to criminal sanction. This pattern of development has also led to the Rule's application, contrary to the principles of due process and notice, in criminal prosecutions. The Rule has thus become the functional equivalent of a residual judi-

²⁰¹ The Justice Department plays a key role in bringing a criminal action under the Securities Exchange Act. If the Commission thinks a criminal prosecution is warranted, it may forward evidence to the Attorney General who will decide, in his discretion, whether to prosecute:

Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this chapter, or of any rule or regulation thereunder, it may in its discretion, bring an action in the proper district court of the United States or United States courts of any Territory, to enjoin such acts or practices and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this chapter.

15 U.S.C. § 78u(e) (1976).

²⁰² See *Developments in the Law—Corporate Crime: Regulating Corporate Behavior Through Criminal Sanctions*, 92 HARV. L. REV. 1227, 1307 (1979).

²⁰³ *Id.* at 1308.

²⁰⁴ *Id.*

²⁰⁵ See note 146 & accompanying text *supra*.

cial power to proscribe any insider trading that is deemed contrary to the fair and efficient operation of the securities markets. Criminal penalties make the Rule a potential deterrent of legitimate securities transactions by insiders. The Commission, with the availability of criminal sanctions, exercises vast discretion in enforcement of the Rule which is potentially harmful to the regulatory scheme as well as unfair to individual defendants. A rule that cannot be applied constitutionally or efficiently in criminal prosecutions has no place in the criminal law. While few individuals may have suffered directly through criminal prosecutions for insider trading violations of 10b-5, the legitimacy of the criminal sanction has been endangered by a rule designed with attention to the demands of economic theory rather than to the demands of the criminal law.²⁰⁶ The imprecision of economic theory has no place in a criminal law in which certainty is a necessary prerequisite. For all these reasons, the criminal prosecution of Rule 10b-5 insider trading violations should cease. If criminal prosecution is a necessary weapon in the SEC's arsenal against insider trading, then that prosecution should be brought under new statutory provisions which would codify the judicial development of Rule 10b-5 to define the conduct proscribed.

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²⁰⁶ See Herlands, *supra* note 77, at 139.