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SECURITIES EXCHANGE ACT OF 1934—RESTRICTIVE APPLICATIONS OF SECTION 10(b) AND RULE 10b-5 IN SECURITIES FRAUD

United States v. Chiarella, 100 S. Ct. 1108 (1980).

I. INTRODUCTION

The Supreme Court again plunged into the thicket of the federal securities laws in its 1979 Term, and emerged with another restrictive interpretation¹ of section 10(b) of the Securities Exchange Act of 1934² and the Securities and Exchange Commission's Rule 10b-5.³ In *United States v. Chiarella*,⁴ the Court overturned the conviction of a financial printer who had used confidential information obtained from his job to make profits

¹ In recent years, the Court has limited the coverage of § 10(b) of the Securities Exchange Act of 1934 both procedurally and substantively. See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (negligence not sufficient grounds for cause of action under Rule 10b-5); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (only purchasers or sellers of securities may bring a private action under Rule 10b-5).

² Section 10 of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j (1976), provides in pertinent part:

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

....

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

³ Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1979), provides:

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

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

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

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

⁴ 100 S. Ct. 1108 (1980).

for himself in the securities market. In taking a narrow approach to section 10(b) and Rule 10b-5, the Court ignored the broad language of these antifraud provisions, disregarded the legislative and administrative purposes behind them, and broke away from administrative and judicial precedents in defining their coverage. In addition, the Court's analysis of the exceptions to the securities laws' general policy of full disclosure failed to distinguish between nondisclosure for legitimate business reasons and nondisclosure for purely personal gain.

Although the Court did not endorse *Chiarella's* activities, its restrictive approach to section 10(b) and Rule 10b-5 allowed patently fraudulent conduct to go unpunished. As the basis for finding that a person's silence operated as a fraud in the purchase of securities, the Court required that the parties to the transaction have a fiduciary or confidential relationship imposing a duty to disclose inside information. But the Court failed to probe the reasons behind the imposition of the duty in those special relationships. Such an inquiry reveals that the duty stems from one party's superior access to inside information and the unfairness of using that information for his benefit alone. The duty does not depend on the label a court can pin upon the parties' relationship.

By rejecting the superior access and unfairness analysis of the duty question, the Court unduly limits the coverage of the antifraud provisions. In the absence of a special relationship, *Chiarella* permits one party to a securities transaction to take advantage of confidential information solely for his personal gain. That result contravenes the language and underlying policies of the antifraud provisions, and bodes ill for the integrity of the securities markets.

II. THE *CHIARELLA* CASE

Vincent Chiarella worked as a "mark-up" man in the print room of the Pandick Press, a financial printer in New York. In the course of his work, he handled documents relating to corporate takeover bids. Although the names of the participating com-

panies appeared in code or were left out of the documents until the final press run, Chiarella deduced their identities from the context of the materials. Armed with the knowledge of impending tender offers, he purchased stock in the target companies and sold it at a premium soon after the acquiring companies publicly announced their takeover bids. Over a period of fourteen months, he made approximately thirty thousand dollars.⁵

Two months after Chiarella executed his last sale, the Securities and Exchange Commission began investigating his activities. The investigation culminated in a consent decree under which Chiarella divested himself of his profits, returning them to the sellers of the stock.⁶

Following the Commission's action, a grand jury indicted Chiarella on seventeen counts⁷ of willful⁸ misuse of material nonpublic information in connection with the purchase and sale of securities in violation of section 10(b) and Rule 10b-5.⁹ After

⁵ *Id.* at 1112. The circuit court opinion noted that Chiarella was a knowledgeable stock trader. In each of the five takeover cases, he derived the name of the target company from other information in the documents, such as price histories, par values, and the number of letters in the mock corporate names. *United States v. Chiarella*, 588 F.2d 1358, 1363 (2d Cir. 1978). Signs posted throughout the print shop contained this warning for employees: "You are forbidden to use any information learned from customer's copy, proofs, or printed jobs for your own or anyone else's benefit." *Id.* at 1369.

⁶ *SEC v. Chiarella*, No. 77 Civ. 2534 (GLG) (S.D.N.Y. 1977).

⁷ He was charged with seventeen counts because he had received seventeen letters confirming his purchases of shares. 100 S. Ct. at 1113 n.3.

⁸ 100 S. Ct. at 1113. Section 32(a) of the 1934 Act, 15 U.S.C.A. § 78ff(a) (Supp. 1972-78), provides in pertinent part:

Any person who willfully violates any provision of this title . . . 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 title . . . shall upon conviction be fined not more than \$10,000, or imprisoned not more than five years, or both . . . but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves he had no knowledge of such rule or regulation.

⁹ Since the promulgation of Rule 10b-5 in 1942, the vast majority of the cases have arisen on the civil side. *See* 3 A. BROMBERG, *SECURITIES LAW: FRAUD* § 10.3 (1977). In *United States v. Charnay*, 537 F.2d 341, 348 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976), the court attributed this phenomenon to early cases holding that the rule provides an implied private right of action in favor of the injured party to enforce the rule's sanctions. *See, e.g.*, *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

The Supreme Court has indicated that the primary difference between criminal and civil actions under the

moving unsuccessfully to dismiss the indictment,¹⁰ Chiarella was tried and convicted on all counts.¹¹ The Court of Appeals for the Second Circuit upheld the conviction.¹²

The Supreme Court, in a split decision, reversed.¹³ In his opinion for the majority, Justice Powell framed the issue as "whether a person who learns from the confidential documents of one corporation that it is planning an attempt to secure control of a second corporation violates section 10(b) of the Securities Exchange Act of 1934 if he fails to disclose the impending takeover before trading in the target company's securities."¹⁴ The answer to that question, the Court said, required an examination of the language and legislative history of the statute, as well as its interpretation by the SEC and the courts.¹⁵

Finding no "specific guidance" in the language

securities laws is the burden of proof required for a verdict. *See SEC v. Joiner Corp.*, 320 U.S. 344, 355 (1943). On the basis of *Joiner*, the *Charnay* court concluded that the precedents established in civil cases interpreting Rule 10b-5 apply to criminal prosecutions under the rule. *United States v. Charnay*, 537 F.2d at 348. *See also United States v. Peltz*, 433 F.2d 48, 53 (2d Cir. 1970) (opinion of Friendly, J.), *cert. denied*, 401 U.S. 955 (1971); *United States v. Clark*, 359 F. Supp. 128, 130 (S.D.N.Y. 1973). By not questioning the applicability of the civil 10b-5 cases in its opinion, the *Chiarella* Court assumed the relevance of their principles in the criminal context. Thus, criminal prosecutions and convictions are possible whenever a Rule 10b-5 violation is willful.

For a general overview of criminal liability under the securities laws, *see Note, The Securities and Exchange Commission: An Introduction to the Enforcement of the Criminal Provisions of the Federal Securities Laws*, 17 AM. CRIM. L. REV. 121 (1979).

¹⁰ *United States v. Chiarella*, 450 F. Supp. 95 (S.D.N.Y. 1978). Chiarella claimed that the indictment failed to charge an offense. *Id.* at 96. The district court held that his acts, if proven, operated as a fraud. *Id.*

¹¹ 100 S. Ct. at 1113. The district court's jury charge permitted a conviction upon a finding that Chiarella willfully failed to inform the sellers of target company stock that he knew of the planned takeovers. *Id.*

Chiarella was sentenced to concurrent prison terms of one year for the first thirteen counts, to be suspended after a month's imprisonment. Imposition of sentence on the remaining counts was suspended. In addition, he faced a probation period of five years following his release from prison. *United States v. Chiarella*, 588 F.2d at 1364 n.7.

¹² *United States v. Chiarella*, 588 F.2d 1358.

¹³ 100 S. Ct. at 1113. Justice Powell wrote the majority opinion, with Justice Stevens writing a concurrence. Justice Brennan concurred in the result. Chief Justice Burger wrote a dissent, as did Justice Blackmun, with whom Justice Marshall joined.

¹⁴ *Id.* at 1112.

¹⁵ *Id.* at 1113.

and legislative history,¹⁶ the Court grounded its holding mainly on its reading of the caselaw. Although the Court recognized that the administrative and judicial precedents establish that silence in connection with the purchase or sale of securities can be a violation, "such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction."¹⁷ The Court expressly rejected the Second Circuit's view that persons who regularly receive material nonpublic information have an affirmative duty to disclose.¹⁸ Instead, the Court emphasized that the duty to disclose arises from a relationship between the parties, not from a person's access to information because of his position in the market.¹⁹ The Court found that Chiarella had no duty to the sellers of target company stock because he had no prior dealings with them.²⁰

Setting forth the essence of the Court's decision, Justice Powell stated:

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 section 10(b) does not arise from the mere possession of nonpublic market information.²¹

The Court noted that it could not affirm the conviction unless it recognized a "general duty between all participants in market transactions to forego actions based on material, nonpublic information."²² The Court refused to create such a duty without some evidence of congressional intent, noting that neither Congress nor the SEC has adopted a "parity of information" rule. On the contrary, the Court said, they have dealt with the problems of misuse of market information through detailed regulation that recognizes that the use of nonpublic information may not always harm the securities markets.²³

¹⁶ *Id.*

¹⁷ *Id.* at 1115.

¹⁸ *Id.* at 1116. The lower court held: "Anyone—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose. And if he cannot disclose, he must abstain from buying or selling." *United States v. Chiarella*, 588 F.2d 1365 (emphasis in original).

¹⁹ 100 S. Ct. at 1116 & n.14.

²⁰ *Id.* at 1116–17. "He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence." *Id.* at 1117.

²¹ *Id.* at 1118.

²² *Id.* at 1117.

²³ *Id.*

The Court declined to decide the question whether Chiarella had breached a duty to the acquiring corporations.²⁴ The Court found that the jury had received no instructions on the breach of duty to anyone except the sellers, and the Court could not affirm a conviction on a theory not presented to the jury. The Court refused to "speculate on whether such a duty exists, whether it has been breached, or whether such a breach constitutes a violation of section 10(b)."²⁵

In his concurrence, Justice Stevens said he agreed that Chiarella owed no duty of disclosure to the sellers, and because the conviction rested on an incorrect theory, he concluded that the Court properly had reversed. He stressed, however, that the Court had not placed "any stamp of approval" on Chiarella's actions; nor had it held that similar actions must be considered lawful in the future.²⁶

Justice Brennan, also in a concurrence, agreed with the Court that no duty to disclose arises from the mere possession of nonpublic market information. But he disagreed that no violation could exist absent the breach of some duty flowing from a fiduciary relationship between buyer and seller. Justice Brennan instead supported the Chief Justice's position that a person violates section 10(b) whenever he improperly converts to his own benefit nonpublic information that he uses in connection with the purchase or sale of securities. Nevertheless, he found that the jury had received no instructions on improper conversion.²⁷

While Chief Justice Burger accepted the general rule that neither party to an arm's length transaction has an obligation to disclose unless they are in a fiduciary relationship, he recognized an exception: a duty to disclose arises whenever a party obtains an informational advantage by unlawful means. The Chief Justice found that section 10(b) and Rule 10b-5 build on this principle, with the result that "a person who has misappropriated

²⁴ *Id.* at 1118.

²⁵ *Id.* at 1119. Justice Stevens observed that Chiarella had breached a duty of silence he "unquestionably" owed to his employer and his employer's customers. Justice Stevens refused, however, to say whether this breach could give rise to criminal liability under Rule 10b-5. He noted a possible argument that the breach of duty to the acquiring corporations worked as a fraud or deceit upon those companies, "in connection with the purchase or sale of any security." He also recognized a counter argument: Since the acquiring corporations could not recover from Chiarella because they were not purchasers or sellers within the meaning of *Blue Chip Stamps*, no actionable violation of § 10(b) had occurred. *Id.* at 1119–20 (Stevens, J., concurring).

²⁶ *Id.*

²⁷ *Id.* at 1120 (Brennan, J., concurring).

nonpublic information has an absolute duty to disclose that information or to refrain from trading.²⁸ And contrary to the majority's view, he found that the jury instructions, read as a whole, did require the jury to find that Chiarella had obtained his advantage "by misappropriating the property of his employer's customers."²⁹

Justice Blackmun, writing in dissent and joined by Justice Marshall, agreed with the Chief Justice's misappropriation theory, but found it unnecessary to rely on it. He would find Chiarella's conduct fraudulent even if Chiarella enjoyed his employer's approval, because his "brand of trading" lay "close to the heart of what the securities laws are intended to prohibit."³⁰ In contrast to the majority's emphasis on the lack of a fiduciary relationship, Justice Blackmun stressed the difference in access to confidential information between Chiarella and the rest of the market. Accordingly, he "would hold that persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities."³¹

III. ANALYSIS: THE BASIC FRAMEWORK

The majority approached the central issue in the case—the legal effect of Chiarella's silence—by reviewing the language, legislative history, and judicial and administrative interpretations of section 10(b) and Rule 10b-5.³² As a beginning, this approach provides a convenient framework for analysis. The Court erred on each of these fronts.

A. LANGUAGE

The Court concluded that the language of section 10(b) offered no guide in deciding the case because it fails to state whether silence may constitute a manipulative or deceptive device.³³ But such

²⁸ *Id.* at 1120-21 (Burger, C.J., dissenting). The Chief Justice concluded:

In sum, the evidence shows beyond all doubt that Chiarella, working literally in the shadows of the warning signs in the print shop misappropriated—stole to put it bluntly—valuable nonpublic information entrusted in him in the utmost confidence. He then exploited his ill-gotten informational advantage by purchasing securities in the market. In my view, such conduct plainly violates § 10(b) and Rule 10b-5.

Id. at 1123.

²⁹ *Id.* at 1122.

³⁰ *Id.* at 1123 (Blackmun, J., dissenting).

³¹ *Id.* at 1126.

³² 100 S. Ct. at 1113.

³³ *Id.*

a reading simply ignores the all-inclusive wording of the statute. Section 10(b) prohibits "in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules or regulations as the Commission may prescribe."³⁴ Rule 10b-5 makes it unlawful for "any person, directly or indirectly . . . [t]o employ any device, scheme, or artifice to defraud [or] . . . [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or a deceit upon any person."³⁵

Although the statute and rule do not on their faces specify that silence constitutes an offense, their wording is broad enough to reach silence when it operates as a fraud. The Supreme Court has said that "[t]hese proscriptions, by statute and rule, are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive."³⁶ In concluding that the lack of specific guidance was no guide at all, the Court disregarded the purpose behind the broad wording. Although its breadth precludes specific guidance, the all-inclusive language nonetheless provides significant general guidance. That language suggests that if Chiarella's conduct in purchasing and selling securities worked as a fraud, it fell within the prohibitions of section 10(b) and Rule 10b-5.

B. LEGISLATIVE HISTORY

The *Chiarella* majority also said that the legislative history of the statute offered no specific direction for the resolution of the case. The Court further noted that when the SEC promulgated Rule 10b-5, it said nothing of the possibility that silence might constitute a violation of section 10(b).³⁷ Yet the Court's opinion failed to treat any of the relevant legislative history; nor did it examine any of the important judicial interpretations of the legislative intent.

The legislative history bearing directly on section 10(b) is indeed sparse. Only one specific reference to the provision appears in the report discussing the Senate's version of the 1934 Act.³⁸ Still, the

³⁴ 15 U.S.C. § 78j (emphasis added). For the full text, see note 2 *supra*.

³⁵ 17 C.F.R. § 240.10b-5 (emphasis added). For the full text, see note 3 *supra*.

³⁶ *Affiliated UTE Citizens v. United States*, 406 U.S. 128, 151 (1971). See also 100 S. Ct. at 1121 (Burger, C.J., dissenting).

³⁷ *Id.* at 1113.

³⁸ S. REP. NO. 792, 73d Cong., 2d Sess. 6 (1934). The report actually discusses § 9(b) of the Senate version of the 1934 Act, S. 3420. That provision became § 10(b) in the final version.

report's brief mention is significant, for it expresses the legislature's view that it could only regulate the securities markets effectively if the Act included "several clear statutory provisions," such as the present section 10(b), "reinforced by penal and civil sanctions, aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function."³⁹ This language indicates that Congress intended the statute to have the flexibility to reach the sort of conduct Chiarella engaged in, which hardly fulfilled any "useful function."

The hearings on the 1934 Act considered only briefly the provision that became section 10(b). According to the Supreme Court in *Ernst & Ernst v. Hochfelder*,⁴⁰ Thomas G. Corcoran, a spokesman for the drafters, gave the "most relevant exposition" of the eventual section 10(b). Corcoran said that the section in essence provides: "'Thou shalt not devise any other cunning devices.'" He described it as a "catch-all clause to prevent manipulative devices," noting that the "Commission should have the authority to deal with new manipulative devices."⁴¹ The Court in *Hochfelder* termed Corcoran's explanation "significant" and said he properly described section 10(b) as a "catch-all."⁴²

As with its analysis of the statutory language, then, the *Chiarella* majority dismissed the legislative history of section 10(b) too cavalierly. That history shows that the draftsmen and the Congress saw section 10(b) as an expansive net that would enable the SEC to capture all varieties of manipulative and "cunning" devices. The Supreme Court has emphasized repeatedly that Congress intended the antifraud provisions of the securities laws to be construed "not technically and restrictively, but flexibly to effectuate [their] remedial purposes."⁴³ While *Chiarella*'s specific conduct may not have entered the contemplation of the drafters, they nevertheless wrote a law with sufficient breadth to reach his deceptive scheme.⁴⁴

³⁹ *Id.*

⁴⁰ 425 U.S. at 202.

⁴¹ *Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934).

⁴² *Ernst & Ernst v. Hochfelder*, 425 U.S. at 203. See also *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 859 (2d Cir. 1968) (en banc), cert. denied sub nom. *Coates v. SEC*, 394 U.S. 976 (1969) ("Indeed, from its very inception, Section 10(b) ... [has] always been acknowledged as [a catchall]").

⁴³ *Affiliated UTE Citizens v. United States*, 406 U.S. at 151. See also *Superintendent of Insurance v. Bankers Life and Casualty Co.*, 404 U.S. 6, 12 (1971); *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963).

⁴⁴ The SEC has said that Congress intended the anti-

The inclusion of the "catch-all" antifraud provision comports with the larger goals behind all of the securities legislation during the 1930s.⁴⁵ The Supreme Court has recognized that a "fundamental purpose" of those laws was "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of ethics in the securities industry."⁴⁶ As for the 1934 Act itself, the Court has noted that Congress intended the Act "principally to protect investors against manipulation of stock prices through regulation of transactions" in the securities markets.⁴⁷ Similarly, the Second Circuit has said that with the 1934 Act, Congress sought "to prevent inequitable and unfair practices and to assure fairness in securities transactions generally."⁴⁸

The judicial emphasis on ethical conduct and fairness in the securities markets agrees with contemporary congressional views on the purposes of the federal securities laws. A 1975 Conference Report, for example, observed that the basic aims of the 1934 Act remain "salutary and unchallenged."⁴⁹ Among others, those goals are "to provide fair and honest mechanisms for the pricing of securities" and "to assure that dealing in securities is fair and without undue preferences among investors."⁵⁰

By using confidential information to gain personal profit, *Chiarella* crossed the bounds of fair dealing and propriety. The judicial interpretations of the legislative intent, as well as Congress' own rephrasing of the goals behind the 1934 Act, suggest that *Chiarella*'s conduct contravened the statute's broad purpose of promoting fairness in the exchange markets.

fraud provisions not as an exclusive specification of the particular acts or practices constituting fraud, but rather "to encompass the infinite variety of devices by which undue advantage may be taken of investors and others." *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

⁴⁵ In addition to the 1934 Act, that legislation included the Securities Act of 1933, the Public Utility Holding Company Act, the Trust Indenture Act, and the Investment Company Act of 1940.

⁴⁶ *SEC v. Capital Gains Research Bureau*, 375 U.S. at 186. See also *United States v. Naftalin*, 441 U.S. 768, 775 (1979).

⁴⁷ *Ernst & Ernst v. Hochfelder*, 425 U.S. at 195. The *Hochfelder* Court elsewhere observed that the extensive legislative history of the 1934 Act is "bereft of any explicit explanation of Congress' intent." *Id.* at 201.

⁴⁸ *SEC v. Texas Gulf Sulphur*, 401 F.2d at 848.

⁴⁹ H.R. CONF. REP. NO. 94-299, 94th Cong., 1st Sess. 91-92, reprinted in [1975] U.S. CODE CONG. & AD. NEWS 322, 323.

⁵⁰ *Id.*

Rule 10b-5's history is less informative than that of section 10(b). The SEC Release announcing the rule's adoption said simply that the new rule would close a loophole in the existing protections against fraud. Whereas the previous rules had applied only to brokers and dealers, new Rule 10b-5 would prohibit "fraud by any person in connection with the purchase of securities."⁵¹ The release does show that the SEC originally intended Rule 10b-5 to have the flexibility to reach fraudulent conduct by any person.⁵²

The Second Circuit⁵³ has offered slightly more guidance with its interpretation of the rule's aims. The "essential purpose" of Rule 10b-5, the court has said, "is to prevent corporate insiders and their tippees from taking advantage of the uninformed outsiders."⁵⁴ Elsewhere the Second Circuit has described the "core of Rule 10b-5" as implementing the congressional purpose that "all investors should have equal access to the rewards of participation in securities transactions," for Congress intended that "all members of the investing public should be subject to identical market risks."⁵⁵ The court noted that Rule 10b-5 reached "inequities based on unequal access to knowledge."⁵⁶

The *Chiarella* majority ignored the broad scope of the rule that the SEC Release suggests. The Court also failed to take account of judicial interpretations of the rule's purpose. Taken together, the release and the Second Circuit's illumination indicate that the aims of Rule 10b-5 included the prohibition of conduct like *Chiarella*'s. The use of his informational advantage plainly operated as a fraud on the sellers of target company stock.

⁵¹ SEC Release No. 3230 (1942). See also [1942] ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION 10.

The Commission hastily drafted the rule over a week-end to meet a particular situation. The Regional Administrator in Boston told the Director of the Trading and Exchange Division that the president of a local corporation was falsely telling other shareholders that the company was performing poorly, inducing them to sell. The president would then purchase their stock as the price fell. See *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967) (remarks of Milton Freeman).

⁵² See *Affiliated UTE Citizens v. United States*, 406 U.S. at 151.

⁵³ Because its jurisdiction includes New York City, the home of the nation's largest securities markets, the Second Circuit has decided the lion's share of the cases involving § 10(b) and Rule 10b-5.

⁵⁴ *Radiation Dynamics v. Goldmutz*, 464 F.2d 876, 890 (2d Cir. 1972).

⁵⁵ *SEC v. Texas Gulf Sulphur*, 401 F.2d at 851-52.

⁵⁶ *Id.*

C. ADMINISTRATIVE AND JUDICIAL INTERPRETATIONS

The Duty Question Under Section 10(b)

Having dismissed the language and legislative history of section 10(b) and Rule 10b-5 as unenlightening, the *Chiarella* Court turned to an examination of administrative and judicial interpretations of those provisions. The Court conceded that the cases establish that silence in connection with the purchase or sale of a security may operate as a fraud within the meaning of section 10(b).⁵⁷ But the Court also found that liability for silence is premised upon a relationship of trust or confidence between the parties to a transaction.⁵⁸ Specifically, the Court pointed to corporate "insiders"⁵⁹ and their "tippees"⁶⁰ as having the duty to disclose because of their special relationship or constructive⁶¹ special relationship to the other party. Finding that *Chiarella* occupied no such relationship with the sellers of target company stock, the Court concluded that he had no duty to disclose the secret information he had learned.⁶²

The majority correctly pinpointed the central issue in the case as a question of duty. *Chiarella* had acquired confidential information; whether he could use that information lawfully to purchase

⁵⁷ 100 S. Ct. at 1115 & n.12.

⁵⁸ *Id.*

⁵⁹ The definition of "corporate insider" typically includes directors, officers, and controlling shareholders. See, e.g., R. JENNINGS & H. MARSH, *SECURITIES REGULATION* 947 (4th ed. 1977). But the term is not an easy one to define exhaustively or with precision. Professor Bromberg has noted that the definition lies not in "organization charts or other well-defined relationships." 2 A. BROMBERG, *supra* note 9, § 7.4(6)(b).

The proposed Federal Securities Code has defined "insider" as including the following:

(1) the issuer, (2) a director or officer of, or a person controlling, controlled by, or under common control with, the issuer, (3) a person whose relationship to the issuer gives or gave him access to a fact of special significance about the issuer or the security that is not generally available.

ALI FEDERAL SECURITIES CODE § 1603 (Proposed Official Draft, 1978). Although the *Chiarella* Court indicated that *Chiarella* was not an insider, he arguably fits within the ALI's definition.

⁶⁰ A "tippee" is a person who learns material, non-public information from a corporate insider. See *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*, 495 F.2d 228, 237 (2d Cir. 1974). The court there held tippees liable under § 10(b) because they knew or should have known of the source of certain information and also knew of its confidential nature, thereby incurring a duty to disclose or refrain from trading. *Id.*

⁶¹ The Court noted the view that a tippee's obligation flows from his role as a participant after the fact in the insider's breach of fiduciary duty. *Id.* at 1115 n.12.

⁶² *Id.* at 1115.

stock without revealing his special knowledge to the sellers depended on whether he had a duty—a legal obligation—to disclose or to refrain from trading. But the question of whether a duty exists begs another inquiry: Where does the duty come from? From its reading of the administrative and judicial precedents, the *Chiarella* Court concluded that the duty derives from a fiduciary or confidential relationship.⁶³ That approach, however, caused the Court to decide the case on the basis of whether it could affix one of those labels on *Chiarella's* relationship with the sellers. The Court's analysis ignored the reasons behind the imposition of the duty. Although the Court chose not to confront them, those reasons do surface unmistakably in the precedents the Court cited.

The seminal administrative interpretation of section 10(b) on the issue of silence and the duty to disclose is the SEC's decision in *Cady, Roberts & Co.*⁶⁴ The SEC laid the foundation for its analysis by noting that corporate insiders must disclose material facts they have learned "by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment."⁶⁵ A failure to disclose under those circumstances plainly violates section 10(b).

The Commission emphasized, however, that the traditional insiders—officers, directors, and controlling shareholders—were not the only individuals upon whom the obligation to disclose rests. The Commission said that analytically, the duty depends on two principal elements:

first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone and second, the inherent unfairness involved when a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.⁶⁶

The SEC noted that in weighing these elements, it refused "to be circumscribed by fine distinctions and rigid classifications," an apparent reference to common law definitions of fiduciary relationships. Rather, the Commission would use the two ele-

ments to identify persons who are in a "special relationship with a company or privy to its internal affairs," thereby creating special duties in trading the corporation's securities.⁶⁷

A restrictive reading of *Cady, Roberts* emphasizes the "relationship" language and concludes that the Commission merely had restated the traditional principles on the duty to disclose. Although the Commission professed to abandon "rigid classifications," it still returned to the idea that only a special relationship with a company creates the duty.⁶⁸ A broader reading of the case, however, stresses the SEC's analysis of the origin of the duty. The duty comes from the access to confidential information and the unfairness of using that information for one's personal gain.

Other administrative cases interpreting the antifraud provisions have analyzed the duty question flexibly. In *Blyth & Co.*,⁶⁹ for example, the Commission held that bond traders had violated the antifraud provisions when they acted on confidential information conveyed to them by an employee of the Federal Reserve Board.⁷⁰ The Commission said that the traders, who knew the information was "intended to be kept nonpublic," had a duty to refrain from effecting transactions in government securities until the Board revealed the data.⁷¹ In *Blyth*, the Commission found a violation even though no special relationship existed between the bond traders and the other parties to their transactions. They had a duty to refrain from trading because they possessed information no other traders had.

In *Investors Management Co.*,⁷² the Commission specifically rejected the argument that only a recipient of inside information occupying a special relationship with an issuer of securities or with a corporate insider could violate the antifraud provisions.⁷³ Rather, the Commission held that when a person obtains nonpublic information which he knows originates from a corporate source, he acquires a "relationship . . . to that information," subjecting him to the restraints.⁷⁴ The antifraud pro-

⁶⁷ *Id.* The Commission concluded by observing that "[i]ntimacy demands restraint lest the uninformed be exploited." *Id.*

⁶⁸ See generally Daum & Phillips, *The Implications of Cady, Roberts*, 17 BUS. LAW. 939, 950 (1962).

⁶⁹ 43 S.E.C. 1037 (1969).

⁷⁰ *Id.* at 1040.

⁷¹ *Id.*

⁷² 44 S.E.C. 633 (1971).

⁷³ *Id.* at 643.

⁷⁴ *Id.* at 644.

⁶³ *Id.*

⁶⁴ 40 S.E.C. 907. *Cady, Roberts* involved a broker who effected advantageous trades in a company's securities for his customers on the basis of nonpublic information he had received from one of the company's directors, who also worked with him in the brokerage firm.

⁶⁵ *Id.* at 911.

⁶⁶ *Id.* at 912.

visions prohibit him from using the information to effect transactions in the corporation's securities for his own benefit.⁷⁵

Blyth and *Investors Management* both support a broad reading of *Cady, Roberts*. In the SEC's view, the crucial inquiries in discerning a duty to disclose center on access and unfairness. For, as the Commission has recognized, Rule 10b-5 "is based in policy on the justifiable expectation of the securities marketplace that all investors... have relatively equal access to material information."⁷⁶

The *Chiarella* Court, however, focused narrowly on the absence of a "special relationship" creating a duty to disclose.⁷⁷ The majority's rigid approach neglected the test the SEC has developed in the *Cady, Roberts* line of cases for analyzing the duty question.⁷⁸ Through his work in the print shop, Chiarella had access⁷⁹ to secret information intended only for a corporate purpose, and he unfairly used that information for his own benefit. His case satisfied the SEC's criteria for the existence of a duty.

The majority acknowledged that a failure to disclose material nonpublic information constitutes fraud when a duty to disclose exists.⁸⁰ The trial judge instructed the jury that it could convict Chiarella if his "alleged conduct... would have or did have the effect of operating as a fraud upon a seller."⁸¹ Had the Court properly analyzed the duty issue in terms of access and unfairness, it would have concluded that Chiarella owed a duty to disclose and that his failure to speak or refrain from trading therefore operated as a fraud. Instead, the Court reversed the conviction because it could not call the relationship between Chiarella and the sellers "fiduciary" or "confidential."

In accord with the administrative cases, the ju-

dicial interpretations of section 10(b) and Rule 10b-5 have emphasized access and unfairness as the central factors in finding a duty to disclose. The cases generally have not turned on the existence of a special relationship, as *Chiarella* now requires. Instead, they support the notion that a person with access to inside information because of his position, or a person who receives confidential information from another person with such access, must disclose or refrain from trading.

In *Speed v. Transamerica Corp.*,⁸² an early 10b-5 case, the court said that the duty of disclosure stems from the need to prevent corporate insiders from using their positions to take unfair advantage of uninformed minority stockholders.⁸³ The court noted that the disclosure requirement attempts to equalize the bargaining positions of the parties.⁸⁴ Even though *Speed* spoke in terms of corporate insiders, the rationale applies with equal force to situations like that in *Chiarella*. When a person is in a position that allows him to learn information not available to the rest of the investing public, fairness dictates that he disclose that information or forego his advantage. For the purpose of identifying a duty of disclosure, the positions of Chiarella and the corporate insider are analytically indistinguishable. Both provide access to information denied to other investors.

Chiarella relied on *Frigitemp v. Financial Dynamics Fund, Inc.*⁸⁵ to establish that the party charged with failing to disclose information must be under a duty to do so.⁸⁶ While *Frigitemp* does support that proposition, the *Chiarella* majority failed to discuss a more significant aspect of the case. In *Frigitemp*, the court had found no duty to disclose on the ground that the party allegedly owing the duty correctly assumed that the other party had access to the relevant information and could easily retrieve it with its own efforts.⁸⁷ With that finding, the court implied that a critical question in deter-

⁷⁵ *Id.*

⁷⁶ Van Alstyne, Noel & Co., 43 S.E.C. 1080 (1969) (quoting SEC v. Texas Gulf Sulphur, 401 F.2d at 848).

⁷⁷ 100 S. Ct. at 1117.

⁷⁸ The majority did set out the test in the text of its opinion, but it failed to apply the two-pronged analysis directly to the facts of *Chiarella*. After mentioning the test, the Court proceeded to discuss the common law principles of fiduciary duty. See 100 S. Ct. at 1114.

⁷⁹ The precise language the SEC used was "relationship giving access." *Cady, Roberts*, 40 S.E.C. at 912. The majority in *Chiarella* apparently considered "relationship" the critical word in the phrase. But such an emphasis needlessly obscures the important point in the case: Chiarella used his position as a printer to acquire information that enabled him to make money unfairly.

⁸⁰ See 100 S. Ct. at 1115.

⁸¹ *Id.* at 1119 (quoting trial record at 686).

⁸² 99 F. Supp. 808 (D. Del. 1951).

⁸³ *Id.* at 829. The court said that one of the primary purposes of the 1934 Act was "to outlaw the use of inside information by corporate officers and principal stockholders for their own financial advantage to the detriment of public security holders." *Id.*

⁸⁴ *Id.*

⁸⁵ 524 F.2d 275 (2d Cir. 1975).

⁸⁶ *Id.* at 282; 100 S. Ct. at 1115.

⁸⁷ *Frigitemp v. Financial Dynamics Fund, Inc.*, 524 F.2d at 282. The issue in the case was whether the Fund violated Rule 10b-5 by failing to disclose to Frigitemp its purchases of Frigitemp shares. The court noted that Frigitemp could learn the information from its own stock transfer sheets. *Id.* at 283.

mining the existence of the duty is whether one party to a transaction has a means of obtaining information unavailable to the other party.

Chiarella recognized that courts have found section 10(b) to bar "tippees" of corporate insiders from trading on information they know is confidential.⁸⁸ The Court took note of the theory that the tippee's obligation rests on his role as a participant after the fact in a corporate insider's breach of fiduciary duty.⁸⁹ While that theory places the tippee cases in the Court's fiduciary duty pigeon-hole, it amounts to little more than a fiction. The tippee occupies no fiduciary relationship with the corporation or its shareholders; he does not acquire the confidential information because of his position in the company. Rather, he stands as the passive recipient of corporate secrets, which he then employs for his personal gain. The "participant after the fact" theory merely obfuscates the true reason for imposing liability on tippees. The tippee may not profit from the confidential information because he had an access not open to the general investing public.⁹⁰

For the purpose of analyzing the duty to disclose, *Chiarella* is no different from a tippee. He stands in no fiduciary relationship with the acquiring corporation, the target corporation, or the target's shareholders. In particular, his relationship with the acquiring corporation is at least as removed as the tippee's relationship to the company that his confidential information concerns. The argument⁹¹ that *Chiarella* breached a fiduciary duty flowing from his attenuated relationship with the tender offeror indulges in a fiction similar to the "participant after the fact" theory of tippee liability. Both

of those approaches gloss over the issues of access and unfairness, which are the analytic underpinnings of the duty. The stark fact remains that *Chiarella*, like the tippee, had superior access to information in comparison with other investors, and the unfairness of using the information should bar his trading.⁹²

Some courts have described the duty to disclose in the broadest possible language, reaching beyond the position of access test. For example, in *SEC v. Texas Gulf Sulphur*,⁹³ the court said in dicta that "anyone in possession of material inside information must either disclose it to the investing public" or abstain from trading if he would violate a corporate confidence by disclosing.⁹⁴ The court justified its position by explaining that the policy behind Rule 10b-5 is to ensure that all investors have "relatively equal access" to material information.⁹⁵

Despite the language and the reasoning of the cases supporting a duty to disclose based upon superior access to inside information, the *Chiarella* Court clung to the notion that a non-insider with no fiduciary relationship to a seller has no obligation to disclose material facts.⁹⁶ Some cases do provide support for this proposition. In *Kohler v. Kohler Co.*,⁹⁷ the court said that the intent of section 10(b) was to create a fiduciary relationship between corporate "insiders" and the "outsiders" with whom they deal in the corporation's securities.⁹⁸ In *SEC v. Great American Industries, Inc.*,⁹⁹ the court noted that a reading of Rule 10b-5 that would place an affirmative duty of disclosure on persons

⁹² In a sense, *Chiarella*'s behavior is even more reprehensible than that of the tippee. *Chiarella* took positive steps to uncover the secret information, whereas a tippee might receive such information without any of his own effort.

⁹³ 401 F.2d 833.

⁹⁴ *Id.* at 848 (emphasis added). See also *Lewelling v. First California Co.*, 564 F.2d 1277, 1280 (9th Cir. 1977) (Rule 10b-5 requires that "those in possession of material information which is not generally available to the other party disclose before selling, or refrain from dealing."); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*, 495 F.2d at 236 (quoting the language from *Texas Gulf Sulphur* with approval).

⁹⁵ *SEC v. Texas Gulf Sulphur*, 401 F.2d at 848. The court went on to describe the "essence" of the rule in the language of *Cady, Roberts*. *Id.* See text accompanying note 66 *supra*.

⁹⁶ 100 S. Ct. at 1115 (citing *General Time Corp. v. Talley Industries, Inc.*, 403 F.2d 159, 164 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969)).

⁹⁷ 319 F.2d 634 (7th Cir. 1963).

⁹⁸ *Id.* at 637.

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

⁸⁸ 100 S. Ct. at 1115 n.12 (citing *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*, 495 F.2d at 237-38).

⁸⁹ 100 S. Ct. at 1115 n.12 (citing [1974] SEC. REG. & L. REP. (BNA) No. 233, at D-1, D-2). See also *Fleischer, Mundheim & Murphy, An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 818 n.76 (1973).

⁹⁰ See *Ross v. Licht*, 263 F. Supp. 395, 409-10 (S.D.N.Y. 1967). There, the court relied on an access test to hold liable under Rule 10b-5 the brother and two friends of the president of a closely held corporation for failing to disclose confidential information about the company's future plans when they purchased stock from minority shareholders.

⁹¹ The *Chiarella* Court noted the possibility that a conviction under § 10(b) could rest on the theory that *Chiarella* breached a duty to the acquiring corporation. But the Court expressed no opinion on this theory, because it had not been presented to the jury. 100 S. Ct. at 1118. See text accompanying notes 24-25 *supra*.

who do not occupy a special relationship with a seller or buyer of securities would "break new ground and require most careful consideration."¹⁰⁰ But these cases fail to look beyond the "insider" or "fiduciary" labels to discover the reason for the special duties that stem from the relationship. Insiders and fiduciaries must disclose because their positions afford them a special access to information that other investors do not have.

In the only Rule 10b-5 case the Supreme Court has decided relevant to the issues in *Chiarella*, the Court's reasoning supports the superior access theory more than it does the fiduciary relationship approach. In *Affiliated UTE Citizens v. United States*,¹⁰¹ a group of American Indians formed a corporation to distribute the tribal assets among its mixed blood and full blood members. The corporation issued stock and appointed a Utah bank as transfer agent. Upon learning that two of the bank's employees had encouraged the sales of Indian shares to non-Indians at prices well below their price on an all non-Indian market, several former shareholders brought suit. They alleged that the bank and its employees had violated section 10(b) and Rule 10b-5 by failing to inform them of the higher prices prevailing on the non-Indian market.

The Court noted that had the bank functioned "merely as a transfer agent, there would have been no duty of disclosure."¹⁰² The Court found, however, that a duty to disclose did exist because the bank had acknowledged its responsibilities to insure that transfers were properly made and to act for individual shareholders in the sale of their stock.¹⁰³ The Court said that the bank employees could not remain silent while facilitating sales from mixed bloods to persons seeking to profit on the non-Indian market, with which the bank employees were fully familiar.¹⁰⁴ Accordingly, the Court held that the defendants' activities in inducing the mixed bloods to sell without informing them of the other market operated as a fraud in violation of Rule 10b-5.¹⁰⁵

The *Chiarella* majority read *Affiliated UTE* to support its position that no duty of disclosure arises absent a fiduciary or insider relationship.¹⁰⁶ Presumably the *Chiarella* Court believed that by un-

dertaking to act in behalf of the Indians in their transfers and sales, rather than "merely as transfer agent," the bank had assumed a fiduciary duty that gave rise to a duty to disclose. This reading, however, again substitutes the "special relationship" label for hard analysis. The Court in *Affiliated UTE* found a duty to disclose not simply because of the bank's undertaking, but more importantly, because of the bank's knowledge of the non-Indian market. Like *Chiarella*, the bank failed to disclose information it knew would affect the Indian shareholders' decision to sell. The duty arose from the bank's superior access to information about the non-Indian market; its pivotal position in transactions from one market to the other gave it a perspective unavailable to the Indian investors. Contrary to the majority's understanding, then, *Affiliated UTE* suggests that "a structural disparity in access to material information is a critical factor under Rule 10b-5 in establishing a duty either to disclose the information or to abstain from trading."¹⁰⁷

The Duty Question at Common Law

The majority in *Chiarella* related to common law fraud principles its position that only a special relationship can create the duty to disclose.¹⁰⁸ An examination of those principles, however, leads to the same conclusion as the analysis of the duty under section 10(b) and Rule 10b-5. The duty derives from a party's superior access to material information.

Dean Prosser has said that, as a general rule, neither party to an arm's length business transaction has an obligation to disclose information to the other unless the parties stand in a fiduciary or confidential relationship.¹⁰⁹ He noted that the rule of nondisclosure properly applies when the parties have equal opportunities for obtaining information.¹¹⁰ Thus a person may sell his house without telling the buyer that it has termites, because the buyer theoretically has the opportunity to inspect the house before he purchases it.¹¹¹

¹⁰⁷ *Id.* at 1126 (Blackmun, J., dissenting).

¹⁰⁸ See 100 S. Ct. at 1114 & n.9.

¹⁰⁹ W. PROSSER, *THE LAW OF TORTS* § 106 (4th ed. 1971). See also James & Gray, *Misrepresentation—Part II*, 37 MD. L. REV. 488, 523 (1978). This general rule, a correlative of the doctrine of *caveat emptor* ("let the buyer beware"), reflects an individualistic philosophy based on freedom of contract. Keeton, *Fraud—Concealment and Nondisclosure*, 15 TEX. L. REV. 1, 31 (1936).

¹¹⁰ W. PROSSER, *supra* note 109, § 106.

¹¹¹ See *Swinton v. Whitinsville Savings Bank*, 311 Mass. 667, 42 N.E.2d 808 (1942).

¹⁰⁰ *Id.* at 460.

¹⁰¹ 406 U.S. 128.

¹⁰² *Id.* at 152.

¹⁰³ *Id.*

¹⁰⁴ *Id.* at 153.

¹⁰⁵ *Id.*

¹⁰⁶ See 100 S. Ct. at 1115.

Prosser observed an "amorphous tendency" by most courts to find a duty of disclosure where a defendant-seller has special knowledge or means of knowledge not open to a plaintiff-buyer and knows that the buyer misunderstands material facts.¹¹² Even the old "termite cases" have undergone reconsideration.¹¹³ He did not, however, see any corresponding tendency in cases where the buyer has the special information, as courts generally allow a buyer to reap the benefits of his diligence and acumen in discovering facts.¹¹⁴ Yet he noted that the law is working toward the conclusion that full disclosure of all material facts must be made whenever "elementary fair conduct" so demands.¹¹⁵ The Second Restatement of Torts supports this view.¹¹⁶

The common law doctrines on the duty to disclose suggest several points relevant to *Chiarella*. First, the general rule of nondisclosure absent a fiduciary relationship is based on the premise that the parties have equal opportunities to learn material facts. In *Chiarella*, the sellers did not have the same opportunity Chiarella had to discover the tender offers. Second, even if the law continues to impose no duty to disclose on the buyer, that rule should apply only where the buyer has acquired the special knowledge through honest efforts and superior skill.¹¹⁷ Chiarella, in the words of the Chief

Justice, "misappropriated—stole to put it bluntly—" the confidential information about the tender offers.¹¹⁸ Finally, the current trend toward a general fairness rule would mandate disclosure by Chiarella, as his silence offends most everyone's sense of elementary fair conduct.

The *Chiarella* Court recognized that Rule 10b-5's restrictions on insider trading grew out of the common law notion that corporate insiders owe a duty to disclose because of their special relationship with other shareholders.¹¹⁹ Similarly, commentators have noted that the origin of 10b-5's prohibitions lies in the common law special circumstances rule.¹²⁰

The United States Supreme Court embraced the special circumstances rule in *Strong v. Repide*.¹²¹ In that case, a director purchased a minority shareholder's stock without disclosing his knowledge of an impending sale of the company's land to the government at a price that would greatly enhance the value of the stock. The Court held that the special facts of the case, including the defendant's position as a director, his controlling interest in the company, and his role as chief negotiator in the land sale, created a duty to disclose his knowledge of the sale.¹²²

Under the *Strong* special facts doctrine, the duty arises because the corporate officer possesses special knowledge gained from his work with the company.¹²³ Since he has access to information unavailable to the average shareholder, he must disclose any special facts affecting the value of the stock before he purchases from such a shareholder. Without this disclosure, the trade would be unfair.

The *Chiarella* situation closely resembles that in *Strong*. Chiarella's position as a financial printer gave him access to knowledge unavailable to the investors with whom he dealt. Fairness requires

¹¹² W. PROSSER, *supra* note 109, § 106. See, e.g., *Strong v. Repide*, 213 U.S. 419 (1909); *Edward Malley Co. v. Button*, 77 Conn. 571, 60 A. 125 (1905).

¹¹³ See, e.g., *Obde v. Schlemeyer*, 56 Wash. 2d 449, 353 P.2d 672 (1960). See also *James & Gray*, *supra* note 109, at 526.

¹¹⁴ W. PROSSER, *supra* note 109, § 106.

¹¹⁵ *Id.* See also Keeton, *supra* note 109, at 31. The federal securities laws reflect this movement. As the Supreme Court has observed, a fundamental purpose of the securities laws was "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*." SEC v. Capital Gains Research Bureau, 375 U.S. at 186. See text accompanying note 46 *supra*.

¹¹⁶ See RESTATEMENT (SECOND) OF TORTS § 551 (1977), which provides:

(2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated,

....

(e) facts basic to the transaction, if he knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts.

¹¹⁷ See Keeton, *supra* note 109, at 25:

It seems that the way in which the buyer acquires the information which he conceals from the vendor should be a material circumstance. The information might have been acquired as the result of his bring-

ing superior knowledge, intelligence, skill or technical judgment; it might have been acquired by mere chance; or it might have been acquired by some tortious action on his part. . . . Any time information is acquired by an illegal act it would seem that there should be a duty to disclose that information.

¹¹⁸ 100 S. Ct. at 1123 (Burger, C.J., dissenting).

¹¹⁹ *Id.* at 1114 & n.10.

¹²⁰ Fleischer, Mundheim & Murphy, *supra* note 89, at 818.

¹²¹ 213 U.S. 419 (1909).

¹²² *Id.* at 432. For a more recent application of the special circumstances doctrine, see *Brophy v. Cities Service Co.*, 31 Del. Ch. 241, 70 A.2d 5 (1949).

¹²³ See 3A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1168.2 (1975).

that he disclose his special knowledge before trading or, because disclosure would violate his employer's rule against revealing secrets learned at work, that he refrain from purchasing the stock. The identical considerations underlying the common law special circumstances doctrine give rise to a duty in a case like *Chiarella*.

IV. ANALYSIS: THE STATUTORY AND REGULATORY SCHEME

The Supreme Court expressly rejected the rule adopted by the Second Circuit in *Chiarella* that "[a]nyone . . . who regularly receives material non-public information" incurs a duty to disclose.¹²⁴ By so doing, the Court necessarily disapproved of the broader dicta in *Texas Gulf Sulphur* that "anyone in possession of material inside information" must either disclose or refrain from trading.¹²⁵ The Court refused to hold that a person owes a general duty to the marketplace to forego transactions based on confidential information.¹²⁶ Instead the Court limited the duty to those instances where a specific relationship exists between two parties.¹²⁷

The Court's reluctance to find a duty in *Chiarella* indicated its desire to restrict the coverage of section 10(b) and Rule 10b-5. The Court apparently feared that an expansive reading of these antifraud provisions might proscribe conduct lying beyond their intended reach. A duty to disclose based on an access to information test would, in the Court's view, be overinclusive. The Court emphasized that it refused to formulate such a broad duty "absent some explicit evidence of congressional intent."¹²⁸

In support of its position, the Court recognized that in the overall statutory and regulatory scheme the use of inside information may not always harm the securities markets.¹²⁹ In particular, the Court pointed to the Williams Act,¹³⁰ which permits a tender offeror to purchase up to five percent of a target company's stock before making a disclosure of its takeover plans.¹³¹ The Court also noted the practice of "warehousing," whereby a tender offeror discusses its plans with an institutional investor before making a public announcement to allow

the institution to acquire shares at the lower pre-offer price.¹³²

By discussing the Williams Act and warehousing, the Court attempted to show that an access to information rule would cause section 10(b) and Rule 10b-5 to cover trading on inside information that Congress and the SEC have permitted. Ironically, however, an examination of both warehousing and pre-announcement purchases by a tender offeror ultimately reveals a basis for limiting the duty to disclose under an access test. The duty arises only when a person has superior access to information that he uses for purely personal gain. If use of confidential information is necessary to advance a legitimate business objective, however, no duty should attach.

In a pre-Williams Act case, *General Time Corp. v. Talley Industries*,¹³³ a target company brought suit against an acquiring company on the theory that the offeror violated Rule 10b-5 by purchasing the target company's stock without disclosing the more favorable terms of its merger plan. The court denied the claim, noting that under the law applicable at the time, a purchaser of stock who was not an insider and who had no fiduciary relation to a prospective seller had no "obligation to reveal circumstances that might raise a seller's demand and thus abort the sale."¹³⁴

The Williams Act changed the rule of *General Time* for acquisitions exceeding five percent of the target's stock. But under *Chiarella*, the court's holding still applies to the purchases up to that level. This approved practice of nondisclosure appears to be at odds with the superior access and unfairness rule.

At first glance, the parallels between *Chiarella*'s activities and a tender offeror's pre-disclosure purchases are striking. The tender offeror has access to material information unavailable to the sellers of target company stock, for the offeror knows it will attempt to acquire the target at a price per share in excess of the pre-offer market price. Similarly, a person in *Chiarella*'s shoes knows that the price of target company stock will rise when the tender offer is announced. Further, the injury to the sellers of target stock is the same. In both cases, knowledge of the tender offer would cause them to demand more money for their shares. Yet the positions of the offeror and *Chiarella* are analytically different for the purpose of imposing Rule 10b-5 liability.

¹³² *Id.* at 1117. See Fleischer, Mundheim & Murphy, *supra* note 89, at 811.

¹³³ 403 F.2d 159.

¹³⁴ *Id.* at 164.

¹²⁴ 100 S. Ct. at 1116.

¹²⁵ See text accompanying notes 93-95 *supra*.

¹²⁶ See 100 S. Ct. at 1117.

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ *Id.*

¹³⁰ 15 U.S.C. § 78m(d)(1) (1976).

¹³¹ 100 S. Ct. at 1117 & n.15.

As the Chief Justice noted in his *Chiarella* dissent, the tender offeror's secret purchases represent a legitimate business practice.¹³⁵ The offeror wishes to "test the water" before it proceeds with the full tender offer.¹³⁶ Moreover, if the tender offer ultimately succeeds, a more efficient business entity should emerge, presumably promoting economic growth.¹³⁷ Chiarella, on the other hand, engaged in no legitimate business activity. Relying on deceptive methods, he pursued financial gain for himself alone.¹³⁸

Furthermore, as the Second Circuit noted in its opinion in *Chiarella*, the offeror takes a risk that Chiarella did not. Chiarella knew he would make a profit when he began his trading activities.¹³⁹ But the tender offeror, despite knowing that the price of target securities will rise once it announces the offer, still has "no alchemic power to transform this knowledge into certain profit."¹⁴⁰ Its initial purchases will appreciate in value only because the market will react to the prospect of the offeror putting up more money. When the price does go up, the offeror, unlike Chiarella, will buy more shares at that higher level, rather than sell the ones it has.¹⁴¹ As a matter of fairness, then, the offeror's nondisclosure is eminently more acceptable than Chiarella's.

In addition to the Williams Act, the *Chiarella* Court discussed "warehousing."¹⁴² The Court deemed especially noteworthy the SEC's attempts to proscribe this practice by special regulation. The majority said that the Commission's proposed Rule 14e-2¹⁴³ evinced the SEC's recognition that any

proceeding against warehousing under section 10(b) "would rest on a 'somewhat different theory' than that previously used to regulate insider trading as fraudulent activity."¹⁴⁴ Curiously, the Court neglected to point out that the SEC never adopted Rule 14e-2, having withdrawn the proposal in December 1979.¹⁴⁵ Moreover, in the release accompanying the proposed rule, the SEC discussed the *Chiarella* litigation, but did not question the conviction or the Second Circuit's reasoning in its affirmance.¹⁴⁶ In fact, the release noted that the proposed rule would "affirm a duty of disclosure" for persons trading on nonpublic information obtained "directly or indirectly from a bidder."¹⁴⁷

Still, when measured against the access test, warehousing appears indistinguishable from Chiarella's trading conduct. Like Chiarella, an institutional investor has access to information unavailable to other investors when it learns that a corporation is planning a tender offer. The institution also knows, as Chiarella did, that if it buys target company stock at the pre-offer price, it will make a profit upon tendering its shares. In addition, the sellers of target stock who have no knowledge of the tender offer incur the same harm in both instances.

Yet warehousing and Chiarella's activities remain vastly different in their purposes. A tender offeror will have valid business reasons for providing an institution with advance notice, as the SEC's *Institutional Investor Study* has acknowledged.¹⁴⁸ For example, the offeror might give notice with the expectation that the institution will establish a position in target company stock and tender its entire block of shares when the offer begins, thereby facilitating the takeover.¹⁴⁹ Alternatively, the pre-

¹³⁵ 100 S. Ct. at 1122 (Burger, C.J., dissenting). The court in *General Time* observed that secrecy has long been the "hallmark of most stock acquisition programs, at least in their initial stages." *General Time Corp. v. Talley Industries*, 403 F.2d at 164.

¹³⁶ 100 S. Ct. at 1122 (Burger, C.J., dissenting).

¹³⁷ See *United States v. Chiarella*, 450 F. Supp. at 97.

¹³⁸ *Id.* See also 100 S. Ct. at 1122 (Burger, C.J., dissenting).

¹³⁹ *United States v. Chiarella*, 588 F.2d at 1366-67.

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² 100 S. Ct. at 1117.

¹⁴³ Proposed SEC Rule 14e-2, SEC Release No. 34-15548, 44 Fed. Reg. 9956, 9987-88 (1979), provided in pertinent part:

(a) It shall constitute a fraudulent, deceptive, or manipulative act or practice within the meaning of section 14(e) of the Act for any person, who knows or has reason to believe that a bidder will make a tender offer for the securities or a class of securities of a specific subject company, and who has received such information directly or indirectly from such bidder, to purchase . . . any security of such target

company if such bidder has not made a public announcement of its intention to make such tender offer, unless at a reasonable time prior to any such purchase such person makes a public announcement by press release or otherwise disclosing the information received and its source.

¹⁴⁴ 100 S. Ct. at 1117-18 (citing 1 SEC, INSTITUTIONAL INVESTOR STUDY REPORT, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. xxxii (1971)).

¹⁴⁵ See SEC Release No. 34-16384, 44 Fed. Reg. 70326 (1979).

¹⁴⁶ SEC Release No. 34-15548, 44 Fed. Reg. 9956, 9977 (1979). The Commission indicated that the new rule would extend the Second Circuit's holding in *Chiarella* to reach other fraudulent practices in connection with tender offers. *Id.*

¹⁴⁷ *Id.* at 9978.

¹⁴⁸ See 5 SEC, INSTITUTIONAL INVESTOR STUDY REPORT, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. 2273 (1971).

¹⁴⁹ *Id.*

announcement notice may afford the institution an opportunity to participate in a financing by the acquiring corporation, also for the purpose of easing the transfer of control.¹⁵⁰ Whatever the reason, however, the offeror's purpose in providing the inside information reaches beyond the mere monetary aggrandizement of the institutional investor.

Thus, despite the harm to the sellers of target company stock, warehousing has valid business purposes behind it. *Chiarella*, by contrast, had no legitimate business objective with his trading. Through his cunning scheme, he intended only to improve his personal financial condition. The culpability of his conduct is manifest.

In its treatment of both the Williams Act and warehousing, the *Chiarella* majority failed to recognize that the exceptions to the general rule against trading on inside information apply only to activities representing legitimate business practices. The statutory and regulatory scheme does not permit an individual to use confidential information purely for his own gain. Indeed, the access to information test has drawn the distinction since its beginnings in *Cady, Roberts*. There, the Commission expressly found that the duty to disclose arises when a person has access to information intended "only for a corporate purpose and not for the personal benefit of anyone."¹⁵¹ In addition, the Senate Report on the 1934 Act implicitly recognized the difference between legitimate business dealings and trading only for personal gain by indicating that the antifraud protections of section 10(b) would aim at those practices "which have been demonstrated to fulfill no useful function."¹⁵²

A duty to disclose deriving from a person's superior access to confidential information remains viable when it incorporates a caveat for legitimate business practices. The *Chiarella* Court's concern that such a duty sweeps too broadly thus appears unwarranted. Properly applied, the access test for

liability under section 10(b) and Rule 10b-5 conforms with the overall statutory and regulatory scheme.

V. CONCLUSION

With its decision in *Chiarella*, the Supreme Court has signaled its unwillingness to give the expansive construction that section 10(b) and Rule 10b-5 require to fulfill their functions as "catch-all" antifraud provisions. By requiring the existence of a talismanic "special relationship" before it will find a duty to disclose inside information, the Court disregards the policies underlying the federal securities laws. The fundamental goal of fair dealing in the securities markets requires that all traders have equal access to information that will affect their investment decisions. Although the ideal of equal access must occasionally yield to legitimate business practices necessitating informational disparity, it should never succumb when a trader employs inside information for selfish gain. The Court's pedantic view of the duty question leaves room for individuals having no "special relationship" to make unfair use of inside information they obtain by dishonest, or even fortuitous, means.

The language and legislative history of section 10(b) and Rule 10b-5 evince the intent of Congress and the SEC to proscribe all varieties of fraudulent practices in connection with the purchase or sale of securities. The administrative and judicial precedents have carried out that intent in developing a workable standard, based on access and unfairness, for determining when silence will operate as fraud. That standard has sufficient flexibility to cover whatever methods human ingenuity can design to gather and use inside information without disclosure. The *Chiarella* Court now requires a recasting of that approach in the superficial terminology of fiduciary or confidential relationships. The Court's narrow vision risks injury to the integrity of the securities markets and can only bring harm to the investing public, the intended beneficiaries of section 10(b) and Rule 10b-5.

GEORGE V. STRONG

¹⁵⁰ *Id.*

¹⁵¹ *Cady, Roberts & Co.*, 40 S.E.C. at 912.

¹⁵² S. REP. NO. 792, 73d Cong., 2d Sess. 6 (1934).