Rule 10b-5 and Non-Traditional Insiders: The Supreme Court Continues Its Retrenchment Trend - Chiarella v. United States

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NOTES
RULE 10b-5 AND NON-TRADITIONAL INSIDERS:
THE SUPREME COURT CONTINUES ITS
RETRENCHMENT TREND——
CHIARELLA V. UNITED STATES

As a result of the disastrous stock market crash of 1929 and its serious after effects on the national economy, President Roosevelt and Congress created statutory reform measures in an attempt to prevent a reoccurrence. Their goal was to impose a system of disclosure that would provide the investing public with information necessary to conduct transactions on the securities exchanges. The products of their intense administrative and legislative work were the Securities Acts of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act).

The 1933 Act was directed at the new issue market, mandating disclosure through registration and reporting requirements in the sale of new issues of securities. The 1934 Act was aimed primarily at the trading markets; its main objective was to protect investors from manipulative and deceptive devices in the purchase and sale of securities. Such investor protection was to be accomplished by a series of pervasive sections which would, inter alia, proscribe practices that undermined investor confidence in the integrity of the securities markets.

One such provision is section 10(b) of the 1934 Act and the attendant Securities and Exchange Commission (SEC) rule 10b-5, which sought to promote investor confidence in the securities market by forbidding devices that would operate as a fraud on any purchaser or seller of any security. In

1. President Roosevelt framed the issue as follows:
   The people of this country are, in overwhelming majority, fully aware of the fact that unregulated speculation in securities and in commodities was one of the most important contributing factors in the artificial and unwarranted "boom" which had so much to do with the terrible conditions of the years following 1929. Letter from President Franklin Roosevelt to Hon. Sam Rayburn (March 26, 1934), reprinted in 5 J. ELLENBERGER & E. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, Item 18 (1973) [hereinafter cited as ELLENBERGER & MAHAR]. Representative Rayburn was chairman of the Interstate and Foreign Commerce Committee which heard testimony and debated the proposed legislation that was to become the 1933 and 1934 Securities Acts.

2. Representative Rayburn instructed that regulation of the stock exchanges and the relationships of the investing public to issuers of securities was necessary because investor confidence in the securities market had dissolved as a result of the 1929 stock market crash. H.R. REP. NO. 1383, 73d Cong., 2d Sess. 1-5 (1934), reprinted in 5 ELLENBERGER & MAHAR, supra note 1, at Item 18.


4. This Note will not examine the 1933 Act. For citations of sources concerning the 1933 Act, see note 32 infra.

5. See notes 32-39 and accompanying text infra.

6. See note 24 infra.

7. See note 25 infra.

8. See notes 24 & 25 infra.
Chiarella v. United States, the United States Supreme Court again interpreted that section and rule in a situation where neither legislative history nor the statute itself offered specific guidance as to resolution of the issue. Contrary to the expansive interpretations assigned those provisions by the federal courts, the Supreme Court held that a financial printer who traded securities based upon material nonpublic information to which he had access by virtue of his employment was under no duty to disclose that information. The Court, therefore, condoned the printer's activities, permitting him to avoid the policies that section 10(b) and rule 10b-5 were enacted to promote.

This Note analyzes the Chiarella Court's interpretation of section 10(b) and rule 10b-5, critically examining the Court's treatment of precedent that should have guided the Court to a result more protective of the investing public. Further, this Note examines several alternative theories upon which a more protective policy could have been grounded. It concludes that the Chiarella decision may have deleterious consequences for the very persons Congress sought to protect.

THE FACTUAL BACKGROUND

Vincent Chiarella was employed as a mark-up man at Pandick Press, a New York City financial printing house. As part of its financial printing services, Pandick Press printed corporate tender offers. To preserve the confidentiality of the tender offers until the acquiring companies desired the information to be made public, Pandick Press was given copy with the target companies' names encoded. Immediately before the final printing, customers supplied Pandick Press with the actual names, which were then inserted into the documents.

10. See notes 41-66 and accompanying text infra.
11. 445 U.S. at 231.
12. A mark-up man is the first employee at Pandick Press to view customer copy. He is responsible for defining the size, style, and depth of type and for routing the pages to copy cutters for distribution to linotype operators. United States v. Chiarella, 588 F.2d 1358, 1363 (2d Cir. 1978).
13. A tender offer is a means by which an acquiring corporation may purchase the outstanding shares of a target company. Such an offer is made to the target company's shareholders for a fixed time, and at a fixed price generally above the prevailing market price. See H. Bloomenthal, 1979 Securities Law Handbook 135 (1979) [hereinafter cited as Bloomenthal]; 2 A. Bromberg & L. Lowenfels, Securities Fraud & Commodities Fraud § 6.3(111) (1969) [hereinafter cited as Bromberg & Lowenfels].
14. 588 F.2d at 1363. The code names often contained the same number of letters as the true names they replaced. Thus, the code name for "Emhart Corp." became "Arabia Corp." and likewise "USM Corp." became "USA Corp." Id.
15. Id.
On five separate occasions between September 1975 and November 1976, Chiarella decoded the fictitious names 16 despite warning signs posted at Pandick Press which forbade personal use of customer information. 17 On the basis of the undisclosed information regarding the imminent tender offers, Chiarella purchased shares of the target companies. He sold the shares immediately after the information was made public and the price had risen. 18 As a result of his use of nonpublic information, Chiarella realized profits in excess of $30,000. 19

Subsequently, the SEC initiated an investigation into Chiarella’s trading activities. 20 Pursuant to a consent decree 21 entered into with the SEC in May 1977, Chiarella returned his profits to the sellers of the target companies’ stock. 22 On January 4, 1978, Chiarella was indicted on seventeen criminal counts 23 of willful misuse of material nonpublic information in connection with the purchase and sale of securities in violation of section 10(b). 24

16. Chiarella, an experienced and knowledgeable stock trader, spoke with his broker as often as ten to fifteen times a day. He deduced the names of the target companies by using other information Pandick Press received in the tender offers, including price histories and par values. Id.

17. The warning signs read as follows:

TO ALL EMPLOYEES:
The information contained in all typeset 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 the 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 without warning.
In addition, you are liable to [sic] 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.

Id. at 1369. The warning notices were posted near the time clock that employees used every day, on the back of their time cards, on various bulletin boards, and in pay envelopes. Further, Pandick Press distributed warning cards to all employees and required that they be signed and returned. Brief for Respondent at 6, Chiarella v. United States, 445 U.S. 222 (1980).

18. See note 13 and accompanying text supra.
19. 588 F.2d at 1363.
21. A consent decree is an agreed order in which the defendant neither admits nor denies the substantive allegations at issue. See Bromberg & Lowenfels, supra note 13, § 1.3(3.20).
22. On the same day, he was discharged by Pandick Press. 588 F.2d at 1364.
23. Section 32(a) of the 1934 Act authorizes criminal prosecutions for willful violations of the 1934 Act or any rule or regulation thereunder. 15 U.S.C. § 78ff(a) (Supp. 1980).
24. Section 10(b) of the 1934 Act provides in pertinent part:

(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 man-
and rule 10b-5. Although Chiarella moved for dismissal of the indictment claiming that it failed to charge a crime, he was eventually found guilty on every count.

On appeal to the Court of Appeals for the Second Circuit, Chiarella's conviction was affirmed. The court held, *inter alia,* that the indictment charged a crime, and that Chiarella's conduct violated his duty as a "market insider" and therefore was in contravention of rule 10b-5. The United

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ipulative 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.


25. SEC rule 10b-5 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 fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1980). Promulgation of rule 10b-5 has been upheld as valid. See Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 786 (2d Cir. 1951) (dictum); United States v. Shindler, 173 F. Supp. 393, 394-95 (S.D.N.Y. 1959) (the rule is a valid exercise of SEC's quasi-legislative function within scope of section 10(b)). It has also passed constitutional challenges on the grounds of vagueness and improper delegation of authority. See Speed v. Transamerica Corp., 99 F. Supp. 808, 831 (D. Del.) (under § 10(b), SEC authorized to adopt antifraud provisions of rule), reaff'd on later motions, 100 F. Supp. 461 (D. Del. 1951), modified on other grounds, 235 F.2d 369 (3d Cir. 1956).

26. United States v. Chiarella, 450 F. Supp. 95 (S.D.N.Y. 1978). Chiarella received thirteen concurrent one-year terms, which were suspended after one month's imprisonment. The sentence was suspended on the remaining counts, and he was placed on probation for five years following his release from prison. 588 F.2d at 1364.

27. 588 F.2d at 1373.

28. The Second Circuit also held that Chiarella had fair notice of potential criminal liability for his conduct. He had contended that to interpret rule 10b-5 as requiring an affirmative duty to disclose to persons other than insiders or "tippees" (those persons receiving tips from insiders) would be an unwarranted extension of the rule and therefore would violate the fair notice element of due process. The court, citing United States v. Persky, 520 F.2d 283, 288 (2d Cir. 1975), noted that due process requires only that "a clear and definite statement of the conduct proscribed" exist before the allegedly criminal action is taken. 588 F.2d at 1369.

Additionally, the Court of Appeals ruled that the government need not prove specific intent to defraud in order to reach a conviction under rule 10b-5. *Id.* at 1370. For this proposition the court cited Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), which determined that the requisite scienter must be something more than negligence but not as great as specific intent. *Id.* at 197, 201.

29. 588 F.2d at 1368. For a discussion of market insiders, see note 121 and accompanying text infra.
States Supreme Court granted certiorari and reversed the lower courts, holding that Chiarella’s conduct did not violate section 10(b). The Court stated that liability is premised upon a duty to disclose nonpublic information and that Chiarella was not subject to such a duty.

**History of Section 10(b) and Rule 10b-5**

The overall goal of the federal securities law is to prevent fraud. A comprehensive and detailed scheme of registration and reporting requirements additionally aims at ensuring a regulated securities marketplace. Section 10(b) of the 1934 Act and rule 10b-5 promulgated thereunder form the heart of the antifraud provisions. Scarce evidence of congressional intent regarding section 10(b) stands in contrast to the numerous judicial interpretations concerning the scope of this section. Similarly, rule 10b-5 was created with little fanfare and was accompanied by little explanation.

34. For discussions of other securities law antifraud provisions, see Bloomenthal, supra note 13, at 68; Jacobs, supra note 32, §§ 3.01[c], [d]; Brudney, supra note 32, at 324.
35. Professor Bromberg noted that of the nearly one thousand pages of testimony in the House of Representatives surrounding the creation of the 1934 Act, the references to § 10(b) "would scarcely fill a page." Bromberg & Lowenfels, supra note 13, § 32.2(331).
36. See, e.g., Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1971) (repeated use of "any" in statute and rule show that their proscriptions are to be broadly interpreted); SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) (design of statute is to protect investors); Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 793 (1969) (statutory objective of 1934 Act is to prevent inequitable and unfair practices in securities market); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 858 (2d Cir. 1968) (purpose of act to "promote free and open public securities markets" and to "secure fair dealing in the securities markets"), cert. denied, 404 U.S. 1005 (1971).
37. Milton V. Freeman, an attorney with the SEC, gave this account of the creation of rule 10b-5:

It was one day in the year 1943, I believe. I was sitting in my office in the SEC building in Philadelphia and I received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, "I have just been on the telephone with Paul Rowen," who was then the SEC Regional Administrator in Boston, "and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at $4.00 a share, and he has been telling them that the company is doing very badly.
purpose was simply stated as prohibiting individuals or companies from buying securities if such purchase involved fraud. Due to the lack of explicit direction from the SEC and Congress, the courts have fashioned their own interpretations of the meanings of section 10(b) and rule 10b-5.

The earliest interpretations of section 10(b) suggested that Congress had not intended to create a private right of action based on a violation, but had merely meant to give the SEC power to deal with fraudulent purchases. Several years after implementing rule 10b-5, however, the SEC, in Karden v. National Gypsum Co., argued that an implied private right of action existed under the rule, and the Karden court agreed. Recognition of a private right of action afforded the SEC the aid of private investors in polic-

whereas, in fact, the earnings are going to be quadrupled and will be $2.00 a share for this coming year. Is there anything we can do about it?" So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17 [dealing with fraud or deception in the offer or sale of securities], and I put them together, and the only discussion we had there was where "in connection with the purchase or sale" should be, and we decide it should be at the end.

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


38. Securities Exchange Act Release No. 3230 (May 21, 1942). Had the Administrative Procedure Act been in effect when rule 10b-5 was created, the administrative history of the rule would have been more explicit. Administrative Procedure Act, § 4(b), 5 U.S.C. § 553(c) (1977) (agencies must provide a clear and concise statement of the basis and purpose of the rules they promulgate).

39. Compare SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) (design of statute is to protect investors) and Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236-40 (2d Cir. 1974) (equal access to information prevents inequitable and unfair practices and ensures fairness) with Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) ("Neither the intended scope of § 10(b) nor the reasons for the changes in its operative language are revealed explicitly in the legislative history of the 1934 Act"). Hochfelder is an early case in the Court’s retrenchment of the scope of § 10(b) liability. See notes 67-76 and accompanying text infra.


42. The Karden court noted that § 10(b) and rule X-10B-5 (as rule 10b-5 was known before a general renumbering in 1956 and 1957) did not explicitly provide a civil remedy for individuals injured by a violation of the section or rule. 69 F. Supp. at 513. The court cited a section of the Restatement of Torts, however, providing that a violation of a legislative enactment creates liability if an actor invades the interests of one whom the statute was intended to protect. See Restatement of Torts § 286 (1934). The court broadly stated that "the disregard of the command of a statute is a wrongful act and a tort." 69 F. Supp. at 513. The Supreme Court later recognized the existence of a private right of action in Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).
ing the securities marketplace;\textsuperscript{43} indeed, there has been a proliferation of rule 10b-5 cases.\textsuperscript{44}

Although courts have encountered few problems in applying section 10(b) and rule 10b-5 to traditional corporate insiders,\textsuperscript{45} extending liability beyond the usual boundaries has met with more resistance.\textsuperscript{46} The extended liability refers to non-traditional insiders, those individuals who by virtue of their position outside the corporate structure are able to affect the securities marketplace.\textsuperscript{47}

The SEC addressed the question of non-traditional insiders in the landmark case \textit{In re Cady, Roberts & Co.}\textsuperscript{48} which involved a broker-dealer who sold certain securities after receiving nonpublic information from a co-worker who also served as a director of the company to which the information pertained.\textsuperscript{49} Determining that the broker-dealer was guilty of unfair trading, the SEC developed an "access and fairness" test.\textsuperscript{50} Under the \textit{Cady, Roberts} test, a violation occurs when information is obtained by means of a relationship giving access to material intended only for a corporate purpose.\textsuperscript{51} The inherent unfairness arises when the individual is aware that
the information is unavailable to those with whom he or she is dealing. In Cady, Roberts, the unfairness arose when the broker-dealer sold shares of the company's stock on his own behalf without disclosing the nonpublic information in his possession.

The Cady, Roberts rationale was affirmed in SEC v. Texas Gulf Sulphur Co., in which certain company employees bought Texas Gulf Sulphur stock for their own use based upon material nonpublic information. The information related to extraordinarily rich mineral deposits at several of the company's exploration sites. The Second Circuit held that anyone in possession of material inside information must disclose it; or, alternatively, if that person is precluded from revealing it in order to protect a corporate confidence, he or she must refrain from trading or recommending the securities in question. Citing the Cady, Roberts access and unfairness test as articulating the "essence of the rule," the Texas Gulf Sulphur court reasoned that the policy behind rule 10b-5 is the expectation that investors trading on the impersonal securities exchanges have relatively equal access to material information. Significantly, while the Cady, Roberts test specifically required a "relationship" giving access to nonpublic information, the Texas Gulf Sulphur court apparently found such a relationship unnecessary. The court ruled that access alone to corporate information prevents an individual from using that information for the personal benefit of anyone.

The trend towards extended liability of non-traditional insiders for non-disclosure next branched to "tippees." During the mid-1970s, the Su-

52. Id.
53. Id. at 908.
54. 401 F.2d 833, 848 (2d Cir. 1968), cert. denied, 404 U.S. 1005 (1971).
55. 401 F.2d at 843-46. In November 1963, when drilling at the site began, Texas Gulf Sulphur stock was selling between 17% and 20%. In early April 1964, the defendants made their stock purchases. By the middle of the month, the company publicized the news of a major mineral discovery, and its stock rose quickly to a high of 32. By May 15, 1964, company stock was selling at 58\(\frac{1}{4}\). Id. at 847.
56. Id. at 878.
57. Id.
58. Id. The court noted that such an expectation exists whether based on traditional fiduciary concepts, see Hotchkiss v. Fisher, 136 Kan. 530, 16 P.2d 531 (1932), or on the "special facts" doctrine, see Strong v. Repide, 213 U.S. 419 (1909). The special facts doctrine, in corporate applications, instructs that when special circumstances make it inequitable for an insider to withhold information from the shareholders, a duty to disclose arises. Concealment constitutes fraud. Taylor v. Wright, 69 Cal. App. 2d 371, 159 P.2d 980 (1945).
59. 401 F.2d at 848. The court stated that the rule is applicable to those individuals who are not traditional insiders. Id. at 848-49.
60. See note 84 infra. See Ross v. Licht, 263 F. Supp. 394, 410 (S.D.N.Y. 1967) (the court stated that certain defendants were not insiders; rather they were tippees and subject to the same duty to disclose nonpublic information or refrain from trading corporate stock as are insiders). In Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974), the court found it "untenable . . . [that] a distinction should be drawn between . . . 'tippers' and 'tippees.' " Id. at 237.
The Supreme Court joined the lower federal courts in giving liberal readings to section 10(b) and rule 10b-5. Representative of this line of cases is *Affiliated Ute Citizens v. United States.* In that case, two bank employees encouraged the creation of a market in Indian-owned Ute Distribution Corporation (UDC) stock by soliciting and accepting orders for UDC stock from non-Indians. The Court determined that the employees were "market makers" and held that their conduct constituted a scheme or device to defraud the Indian sellers under rule 10b-5. As active market-makers, the employees were found to have had a duty to disclose the non-Indian market price to the selling stockholders. The Court concluded: "These proscriptions, by statute [section 10(b)] and rule [10b-5], are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive." Under such an interpretation of section 10(b) and rule 10b-5 a broad class of potential defendants is created.

Post-1975 cases, however, reveal a retrenchment by the Supreme Court to a conservative position regarding non-traditional insiders and the elements of section 10(b) and rule 10b-5 violations. In *Blue Chip Stamps v. Manor Drug Stores,* the Court addressed the issue of whether offerees of a stock offering could maintain private causes of action when they alleged that the offeror has violated rule 10b-5, but when the plaintiffs were neither purchasers nor sellers of the offered shares. The Court held that only an

61. See, e.g., Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971). In *Bankers Life,* the petitioner argued that a corporation it was liquidating was defrauded by a fraudulent sale of its securities. *Id.* at 7. The fraud was perpetrated by an individual who conspired to use funds owned by the corporation rather than outside monies to purchase its securities. *Id.* at 7-9. The Court held that a § 10(b) violation occurred because the corporation was injured through a deceptive device that precluded it from receiving compensation from the sale of its securities. *Id.* at 10. The Court stated that "§ 10(b) must be read flexibly, not technically and restrictively." *Id.* at 12. Similarly, in *SEC v. Capital Gains Research Bureau, Inc.,* 375 U.S. 180 (1963), the Court observed that the securities laws had as their purpose full disclosure rather than caveat emptor. *Id.* at 186. The legislation must be read "flexibly to effectuate its remedial purposes." *Id.* at 195.


63. *Id.* at 153. The employees failed to disclose to the Indian shareholders that higher stock sale prices were available in the non-Indian market than in the Indian market, where Indians traded only among themselves.

64. *Id.*

65. *Id.* at 151. See notes 24 & 25 and accompanying text supra.

66. See text accompanying notes 45-47 supra.


69. *Id.* at 725.
actual purchaser of shares could invoke rule 10b-5.\textsuperscript{70} It feared that failure to follow that principle could lead to a widely expanded class of plaintiffs and foster vexatious litigation.\textsuperscript{71} The Court also recognized that the "very pendency of a lawsuit" could disrupt normal business operations unrelated to the lawsuit.\textsuperscript{72}

The Court's opinion in \textit{Aaron v. SEC}\textsuperscript{73} is a further illustration of the trend. \textit{Aaron} emphasized the requirement of scienter in a private cause of action under section 10(b) and rule 10b-5. The Court narrowly interpreted section 10(b)'s language\textsuperscript{74} to conclude that the section refers to knowing or intentional misconduct.\textsuperscript{75} The Supreme Court's decision in \textit{Chiarella} is apparently consistent with the post-1975 trend. The Court refused to affirm Chiarella's conviction, fearing that otherwise it would create, in effect, a general duty for all those in the securities markets to disclose nonpublic information or to refrain from trading on that information.\textsuperscript{76}

\textbf{The Majority's Analysis}

Despite the general policy in favor of investor protection, the majority\textsuperscript{77} held that Chiarella's conduct was not violative of section 10(b) or rule 10b-5 because a duty to disclose before trading does not arise from mere possession of nonpublic market information.\textsuperscript{78} The Court stressed the prerequisite affirmative duty to disclose and relied upon the common law fraud doctrine which requires the presence of a fiduciary relationship giving rise to such a duty.\textsuperscript{79} The foundation for the Court's argument was \textit{In re Cady, Roberts &

\textsuperscript{70} Id. at 731.
\textsuperscript{71} Id. at 739. The Court quoted with approval Judge Hufstedler's dissent in the Ninth Circuit's decision of \textit{Blue Chip Stamps}:

The purchaser-seller rule has maintained the balances built into the congressional scheme by permitting damage actions to be brought only by those persons whose active participation in the marketing transaction promises enforcement of the statute without risk of abuse of the litigation process and without distorting the securities market.

\textit{Id.} (quoting Manor Drug Stores v. Blue Chip Stamps, 492 F.2d 136, 147 (9th Cir. 1973) (Hufstedler, J., dissenting)).

\textsuperscript{72} 421 U.S. at 740.
\textsuperscript{73} 100 S. Ct. 1945 (1980).
\textsuperscript{74} See note 39 and accompanying text \textit{supra}.
\textsuperscript{75} 100 S. Ct. at 1956. The Court, in essence, reaffirmed its decision in \textit{Ernst & Ernst v. Hochfelder}, 425 U.S. 185 (1976), a case in which the terms "manipulative," "device," and "contrivance" were found to refer clearly to "knowing," "knowing or intentional misconduct." \textit{Id.} at 197-201.

\textsuperscript{76} 445 U.S. at 233.
\textsuperscript{77} \textit{Chiarella} was a six to three decision, with two dissenting opinions. However, Justice Brennan concurred only with the judgment, preferring Chief Justice Burger's dissent as the correct interpretation of the substantive law of section 10(b). \textit{Id.} at 238-39. Justice Marshall joined in the dissent written by Justice Blackmun. \textit{Id.} at 245-52.

\textsuperscript{78} \textit{Id.} at 235.
\textsuperscript{79} \textit{Id.} at 228. The Court observed that a relationship of trust and confidence between insiders of a corporation and its shareholders gives rise to a duty to disclose or refrain from
Co., where the SEC grounded the disclosure duty on the existence of two elements. The SEC stated first that there must be a relationship permitting access to material information unavailable to the public, and second, that unfairness must result from allowing an insider to trade on such information. The Supreme Court in Chiarella, however, focused upon the relationship factor that creates a duty to disclose, ignoring the unfairness element. The Court found that the requisite relationship did not exist between the petitioner and the sellers of the target company stock. Concluding that Chiarella was not a corporate insider, the Court observed that he had not received any confidential information from the target companies and therefore was not a tippee. Because no relationship existed between Chiarella and the sellers of the target company stock, no duty arose to disclose the nonpublic tender offer information.

The majority criticized the Second Circuit’s determination of to whom the duty to disclose applies. The appellate court had affirmed Chiarella’s

trading in the corporation’s securities. Id. The notion of disclosure of nonpublic information or abstention from trading was first articulated in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 404 U.S. 1005 (1971), wherein the court stated:

Thus, 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 chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.

Id. at 848.

81. See notes 50-53 and accompanying text supra.
82. 445 U.S. at 227-28. The "relationship test" utilized by the Court is based on fiduciary or trust concepts. As support for this position, the Court cited SEC v. Great Am. Indus., Inc., 407 F.2d 453, 460 (2d Cir. 1968) (to read rule 10b-5 as imposing duty of disclosure on those other than insiders would require "most careful consideration"), cert. denied, 395 U.S. 920 (1969); General Time Corp. v. Tally Indus., Inc., 403 F.2d 159, 164 (2d Cir. 1967) (knowing of no rule imposing an obligation to disclose on those without insider status or fiduciary relation), cert. denied, 393 U.S. 1026 (1969); Kohler v. Kohler Co., 319 F.2d 634, 637 (7th Cir. 1963) (§ 10(b) creates a form of fiduciary relationship between insiders and outsiders with whom they deal); RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1977) (matters known to an individual by virtue of fiduciary or similar relation to be disclosed). For a general discussion of fiduciary responsibility, see 3 L. Loss, SECURITIES REGULATION 1445-53 (2d ed. 1961); 6 id. 3557-72 (1969).
83. 445 U.S. at 231-35.
84. Id. If Chiarella had received confidential information from the target company, he would have been classified as a "tippee." Tippees are persons given inside information by insiders in other than the insider's business capacity. Bromberg & Lowenfels, supra note 13, § 7.5(2). See Keohner v. Textar Corp., 286 F. Supp. 340 (S.D. Texas), (tippee is person having access via insider to information to be used only for corporate purposes and not for anyone's personal benefit), aff'd, 412 F.2d 700 (5th Cir. 1969). Tippees of corporate insiders have been held liable under § 10(b) based on their duty to avoid profiting from inside information that they know is confidential. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237-38 (2d Cir. 1974).
86. 445 U.S. at 231-35.
conviction by holding that the duty to disclose material nonpublic information falls upon "[a]nyone—corporate or not" 87 who regularly receives such information. Its decision rested on a parity principle—that the federal securities laws were created to provide a system of "equal access to information necessary for reasoned and intelligent investment decisions." 88 The Supreme Court refused to extend liability under section 10(b) and rule 10b-5. Such an extension, the Court stated, would impose a general duty on all participants in market transactions either to disclose nonpublic information or to refrain from trading on the basis of such information. 89 According to the Court, a broad duty should not be properly imposed in the absence of explicit evidence of congressional intent. 90 The Court concluded that without such evidence, the mere possession of nonpublic information would not be considered fraudulent absent an initial duty to speak. 91

Having determined that the petitioner owed no duty to the sellers of the target company's stock, the Court then addressed the government's contention that Chiarella had breached a duty to the acquiring corporation. The government contended that such a duty arose when Chiarella traded on information obtained by virtue of his position as an employee of the printer hired by that corporation. 92 The Court did not resolve that issue, however, because it had not been submitted to the jury. 93 The question of whether a

87. 588 F.2d at 1365 (emphasis in original).
88. Id. at 1362. For other applications of the parity of information principle, see Coates v. SEC, 394 U.S. 979 (1969) (rule 10b-5 is based on policy that investors have equal access to information and is an implementation of Congress' purpose that all investors should have equal access to rewards of trading); Smallwood v. Pearl Brewing Co., 489 F.2d 519, 600 (5th Cir. 1974) ("prompt disclosure helps to insure . . . equal access to market information"); SEC v. Texas Gulf Sulphur, 401 F.2d 833, 848 (2d Cir. 1968) ("rule based on justifiable expectation of securities marketplace that all investors . . . have relatively equal access to material information"), cert. denied, 404 U.S. 1005 (1971).
There is, however, little legislative support for the parity of information approach. References in the congressional reports, which are used as authority for this concept, deal mainly with the disclosure provisions of the 1934 Act. H.R. REP. No. 1383, 73d Cong., 2d Sess. 5, 6, 11 (1934), reprinted in 5 ELLENBERGER & MAHAR, supra note 1, at Item 21; S. REP. No. 792, 73d Cong., 2d Sess. 3 (1934), reprinted in 5 ELLENBERGER & MAHAR, supra note 1, at Item 17.
89. 445 U.S. at 233.
90. Id. at 233-34.
91. Id. The Court acknowledged that silence in the purchase or sale of securities may be fraudulent under § 10(b), but liability would be grounded on an initial duty to disclose the relevant nonpublic information. Id. at 229-30. See Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972). In that case, certain bank employees may have made no representations or recommendations regarding specific securities; yet, the duty arose because the employees agreed to act on behalf of the holders of those securities. See also SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 404 U.S. 1005 (1971). In Texas Gulf Sulphur, the Second Circuit found the defendants, who were corporate insiders, guilty of violating rule 10b-5 based on a pre-existing duty to disclose which arose out of their positions with the company. No deception was practiced in the sale itself. Id. at 853-54.
92. 445 U.S. at 235-36.
93. The SEC argued that the district court's jury charge had stressed that § 10(b) and rule 10b-5 were violated by a fraud perpetrated on "any person" in connection with a purchase or
person trading on material nonpublic information has a duty to "disclose or refrain" to parties other than actual buyers or sellers, therefore, was reserved by the Court. That the Court left the issue unresolved is perplexing in light of Justice Stevens' concurring opinion which noted that only actual purchasers or sellers may raise a private rule 10b-5 action. Because the acquiring companies were not purchasers or sellers in the transactions at issue they would be precluded from raising a cause of action under rule 10b-5. Therefore, the Court was needlessly hesitant to address the issue and refute the government's theory.

The purpose of the federal securities laws is to create a securities market which provides reliable information for investors and prevents investors from being harmed by those with trading advantages. Because Chiarella's acts apparently struck at the very center of the infractions the securities laws were designed to prevent, the Supreme Court's reversal of his conviction stands in contrast to legislative expectations of the protective function of the 1934 Act.

CRITICISM OF THE MAJORITY'S OPINION

Chiarella represents another indication of the Supreme Court's apparent desire to contract rule 10b-5 liability. The Court's analysis in Chiarella may be criticized on several grounds. First, the Court failed to recognize the

sale of securities. Because the phrase contained no limitation on the category of persons who may be harmed by a fraudulent scheme, the SEC asserted that it reached fraudulent practices aimed at businesses as well as individual investors. The SEC concluded that the district court's charge permitted the jury to find that petitioner's conduct was a fraud on both the sellers of the target company's stock and the acquiring companies. Brief for Respondent at 28-30, Chiarella v. United States, 445 U.S. 222 (1980).

The majority, however, concluded that the jury instructions allowed the petitioner to be convicted merely because of his failure to disclose material nonpublic information to the sellers. No references to a duty owed to the acquiring corporations were included. 445 U.S. at 235-37. The Court refused to consider an issue that had not been submitted to the jury. Id. See Dunn v. United States, 442 U.S. 100, 106 (1979) (upholding conviction on a charge not presented to jury offends most basic due process notions); Rewis v. United States, 401 U.S. 808, 814 (1971) (jury not charged with elements of crime of which defendants were convicted). Cf. Eaton v. City of Tulsa, 415 U.S. 697, 698-99 (1974) (per curiam) (question is not upon what evidence trial judge could find petitioner guilty, but rather upon what evidence trial judge did so).

95. Id. See also Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). For a discussion of Blue Chip Stamps, see notes 68-72 and accompanying text supra.
98. See notes 67-76 and accompanying text supra.
language of the securities laws which suggests that their primary purpose is
to protect the investing public from individuals in a position to manipulate
the market. Second, the Court’s utilization of case law is subject to criticism
because its unduly narrow interpretations of those cases did not take into
account the protective policies behind the section and rule. Finally, the
Chiarella court refused without adequate explanation to adopt a “parity of
information” rule that the Second Circuit suggested would impose liability
on acts such as those committed by Chiarella.

The Court initially observed that the language of section 10(b) does not
reveal whether silence may be a manipulative or deceptive device. It
further noted that the enactment of rule 10b-5 was unaccompanied by guide-
lines indicating that silence might constitute the type of manipulative or
deceptive device prohibited by the rule. Although the Court was tech-
nically accurate, statements made by the drafters of section 10(b) indicate
that their intent was to create an expansive net of liability over those who
violate the section. Significantly, the principal drafter observed that the
pertinent section meant that “[t]hou shalt not devise any cunning devices” and
was intended to be a catch-all clause for ensnaring those who employed
manipulative devices. The catch-all purpose has since been adopted by

99. 445 U.S. at 226. Justice Powell, writing for the majority, focused on the legal effect
of Chiarella’s silence. Id. The Court determined that only rules 10b-5(a) and (c) were necessarily at
issue. Id. at 226 n.5. Rule 10b-5(b), not considered by the Court, relates to untrue statements
or material omissions of facts. It was deemed inapplicable because the petitioner made no actual
statements in his securities scheme. Id. See also note 91 supra.

the rule had been created to “close a loophole” in the securities laws by prohibiting the acquisition
of securities through fraudulent means. Prior to the release, the antifraud rules applied
solely to brokers and dealers. After the release, however, the antifraud proscription was ex-
tended to both individuals and companies. Id.

101. 78 Cong. Rec. 8164 (1934), reprinted in 4 Ellenberger & Mahar, supra note 1, at
Item 10; 78 Cong. Rec. 2271 (1934), reprinted in 4 Ellenberger & Mahar, supra note 1, at
Item 5; H.R. Rep. No. 1383, 73d Cong., 2d Sess. 32-33 (1934), reprinted in 5 Ellenberger &
Mahar, supra note 1, at Item 20.

102. Thomas G. Corcoran, counsel for the Reconstruction Finance Corporation, was selected
by the Roosevelt administration in its effort to enact the legislation that eventually was incorpo-
rated in the 1934 Act.

103. Corcoran’s reference was to § 9, which was renumbered § 10 before the proposed leg-
islation became law. The government’s theory behind § 9 was that it would proscribe manipula-
tive devices having the effect of misleading the investing public as to the actual value of secu-
rities. Such a rule was necessary, the government argued, to prevent a recurrence of those
securities market practices that preceded the 1929 stock market crash. H.R. Rep. No. 1383,
73d Cong., 2d Sess. 2-3 (1934), reprinted in 5 Ellenberger & Mahar, supra note 1, at Item 18.

104. Mr. Corcoran presented the government’s position as one which gave the SEC broad
authority to deal with such devices via § 9, described as a “catch-all clause” to prevent man-
ipulative devices. Id. Although this evidence about the breadth of § 9 is only semi-official (testi-
mony before the House hearing on the proposed 1934 Act legislation), it firmly indicates that
the section was intended to be expansive.
several courts. Consistent with this acceptance of an all inclusive class of violators, the SEC itself interpreted rule 10b-5 as prohibiting fraud by any person in securities purchases. Based upon this interpretation of congressional intent, and administrative and judicial understanding of that intent, the Chiarella majority should have found the petitioner’s conduct within the scope of proscribed activity and therefore subject to sanctions. Such a determination would promote investor confidence in the market and deter others from instigating manipulative schemes. Arguably, therefore, the Court should have accorded more weight to the effect of Chiarella’s acts, especially in light of the SEC’s express determination that section 10(b) and rule 10b-5 are applicable to any person.

The Chiarella Court, ignoring the protective purposes behind the anti-fraud provisions of the securities laws, interpreted In re Cady, Roberts & Co. as imposing a duty to disclose based on the relationship that creates the access allowing an individual to receive inside information. Couching its analysis solely in terms of traditional insiders, the Court failed to acknowledge that the SEC had instructed in Cady, Roberts that liability for section 10(b) violations is not limited to those occupying traditional insider positions. A more faithful reading of Cady, Roberts, however, is that access is the crucial element, not the traditional insider relationship creating that access. Indeed, the SEC has specifically rejected the special rel-

105. Herpick v. Wallace, 430 F.2d 792, 801 (5th Cir. 1970) (§ 10(b) written as a “catch all” to reach practices contrary to public interest or interest of investors); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 859 (2d Cir. 1968) (recognizing that from its inception § 10(b) has always been acknowledged as a catch-all), cert. denied, 404 U.S. 1005 (1971); Garner v. Pearson, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,549 (M.D. Fla. 1974) (statute and rule designed to encompass infinite variety of manipulative devices).

106. 8 SEC ANNUAL REPORT 10 (1942). The SEC noted that rule 10b-5 was adopted as an additional protection to investors. Id.


108. 445 U.S. at 226-29. The Court interpreted the Cady, Roberts relationship criterion as based on fiduciary principles existing between the shareholders of a corporation and insiders who received nonpublic information via their corporate position.

109. Id.

110. The SEC directed that officers, directors, and controlling shareholders “do not exhaust the classes of persons upon whom there is such an obligation [to disclose nonpublic information].” SEC v. Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961). The SEC emphasized that the antifraud provisions pointedly referred to “any person.” Id. It based the obligation to disclose on two principal elements: First, the existence of a relationship, giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

111. See Bromberg & Lowenfels, supra note 13, § 7.4(6)(b) (“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,’ according to the test just quoted”).
tionship test in favor of an access criteria that makes an actor liable under the antifraud provisions when he trades on nonpublic information which places him at an advantage in the market.\(^\text{112}\) Similarly, the Court failed to acknowledge the “possession test” enunciated in SEC v. Texas Gulf Sulphur Co.,\(^\text{113}\) which provided that anyone in possession of material inside information must disclose it or refrain from trading.\(^\text{114}\) The possession test has received favorable responses from courts and commentators alike.\(^\text{115}\) The policy underlying rule 10b-5, as the court in Texas Gulf Sulphur recognized, stems from the justifiable expectation of equal access to market information among investors.\(^\text{116}\) That expectation, coupled with a viable possession test, could have provided the majority in Chiarella with a justification for affirming the Second Circuit’s decision. The Court, however, ignored the compelling logic of Texas Gulf Sulphur and instead relied upon an unduly narrow interpretation of who may be liable under the antifraud provisions of the securities laws.

The Court attempted to parallel Chiarella’s conduct to the defendant’s conduct in General Time Corp. v. Talley Industries, Inc.\(^\text{117}\) The majority

\(^{112}\) In re Investors Management Co., 44 S.E.C. 633, 644 (1971). In that case, the SEC decided that one in possession of material nonpublic information, which by itself places him in a superior position to other investors, acquired a relationship with respect to that information within the purview and restraints of the antifraud provisions. Id. The Commission rejected the contention that no violation would occur unless the recipient actually occupied a special relationship with the issuer that provided access to nonpublic information. Id. at 643.

\(^{113}\) 401 F.2d 833, 848 (2d Cir. 1968), cert. denied, 404 U.S. 1005 (1971).

\(^{114}\) Id.

\(^{115}\) See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236-37 (2d Cir. 1974) (possession test is correct to effectuate the policies behind the section and rule); Strong v. France, 474 F.2d 747, 752 (9th Cir. 1973) (duty to disclose arises upon possession of inside information); Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 887 (2d Cir. 1972) (rule 10b-5 intended to prevent those in possession of material inside information from using that information to their own advantage when dealing with others not in possession of same information); SEC v. Lum’s, Inc., 365 F. Supp. 1046, 1057-58 (S.D.N.Y. 1973) (defendant in possession of material nonpublic information owed a duty to investing public not to disclose it to someone for his or her personal use); SEC v. Shapiro, 349 F. Supp. 46, 52-53 (S.D.N.Y. 1972) (section and rule aimed at promoting fair and honest market by preventing those in possession of material inside information from profiting).

Commentators have similarly endorsed the possession test. See Painter, Rule 10b-5: The Recodification Thicket, 45 Syr. Johns L. Rev. 699, 708 (1971) (possession is the better test); Sandler & Conwill, Texas Gulf Sulphur: Reform in the Securities Marketplace, 30 Ohio St. L.J. 225, 238-42 (1969) (anyone in possession of material inside information can take advantage of the public and should be subject to rule 10b-5; no justification for allowing profit at public’s expense); Note, How Big a House of Cards? Private Actions and Insider Trading Under Rule 10b-5, 6 San Diego L. Rev. 243, 263 (1969) (recognizing the possession test as creating a larger class of potential defendants, furthering dissemination of information, and creating liability for heretofore nonculpable conduct).

\(^{116}\) 401 F.2d at 848. See notes 56-58 and accompanying text supra.

\(^{117}\) 403 F.2d 159 (2d Cir. 1968), cert. denied, 393 U.S. 1026 (1969). For additional support, the majority also cited SEC v. Great Am. Indus., Inc., 407 F.2d 453 (2d Cir. 1968), cert. denied, 395 U.S. 920 (1969), and Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963). Great
cited *General Time* for the proposition that a purchaser of securities owes no duty to a prospective seller if he or she is neither an insider nor a fiduciary having an obligation to reveal material facts.\(^\text{119}\) The majority's reliance on *General Time* was misplaced because the purchasers in that case were tender offerors not subject to a duty to disclose nonpublic information in their possession.\(^\text{119}\) Chiarella, however, was not a tender offeror and therefore could not claim an exclusion from the disclosure requirement.\(^\text{119}\) Rather, Chiarella fit within the category of a "market insider," a term suggested by the Second Circuit to describe a person having regular access to market information.\(^\text{119}\) By virtue of his position as a financial printer, Chiarella had access "to the most confidential information in the world of finance"—advance notice of corporate tender offers. Adoption of the "market insider" category would have allowed the majority to act consistently with one of the major purposes of the antifraud provisions—the protection of the integrity of the securities market.

*American Industries* observed that placing a duty of disclosure on those other than traditional insiders or broker-dealers would be "occupying new ground" and would necessitate "the most careful consideration." \(^{118}\) The Second Circuit, however, appeared to state only that careful consideration should be exercised before expanding liability, not that expansion is prohibited. The *Chiarella* Court's refusal to interpret *Great American Industries* as leaving open the possibility for "careful consideration" of a broader duty rule is at odds with the purposes behind the antifraud statutes.

*Kohler* recognized that one of the primary purposes behind the 1934 Act was to proscribe the use of inside information by directors, officers and controlling shareholders. 319 F.2d at 638. The *Kohler* court then extended the principle to include corporations themselves. *Id.* Thus, the expansion of established doctrines in the securities law field has not been scrupulously avoided by the courts. *Chiarella,* in fact, would have been an ideal case in which to base an extension to "new grounds," supported by the policy behind the antifraud laws and the catch-all application of § 10(b).

118. 445 U.S. at 229 (citing *General Time Corp. v. Talley Indus., Inc.*, 403 F.2d 159, 164 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969)).

119. 403 F.2d at 164-65. The Second Circuit observed that the transactions at issue in *General Time* predated the adoption of the Williams Act, which imposed disclosure requirements on certain tender offerors. As a result, the tender offerors in *General Time* were not subject to a duty to reveal nonpublic information in their possession. *Id.*

120. The appellate court rejected Chiarella's argument that he stood in the same position as the tender offerors from which he derived his inside information, 588 F.2d at 1368 n.15. A tender offeror, unlike Chiarella, does not regularly receive nonpublic information concerning any stock but its own. *Id.* at 1366. Additionally, the offeror does not receive information but instead creates it. *Id.*

121. *Id.* at 1365. Chief Judge Kaufman differentiated between corporate insiders and market insiders. The latter have access to information that affects the price of a company's securities but that does not similarly affect a firm's earning power or assets. The Chief Judge applied the market insider theory to Chiarella, finding that financial printers were a "central cog" in the execution of tender offers. *Id.* Because of their strategic position within the securities market, the court concluded that they must be forbidden from profiting from market information they might acquire. *Id.* See also Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. Pa. L. Rev. 798 (1973) [hereinafter cited as Fleischer]. Fleischer suggested that *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), stands for the proposition that the prohibitions under the antifraud rules can be extended to those in a special relationship to the securities market. Fleischer, *supra*, at 819.

122. 588 F.2d at 1365.
The majority also understated the significance of Chiarella's conduct by erroneously interpreting the term "market information." The Court concluded that the market information upon which he acted did not concern the earning power of the target companies or their operations but only their future plans. Market information, however, relates to factors which affect the price of a company's stock, rather than its earning power or future plans. As such, Chiarella's knowledge of the market information (impending tender offers) put him in a superior position to purchase target company securities and be assured of a profit upon their sale. The Court also ignored the effect of Chiarella's activities on the market itself. By entering the market, he affected the price of the stock by exerting on it an artificial upward pressure.

By asserting that not every occasion of financial unfairness constitutes fraud, the Court misread the dictates of Santa Fe Industries, Inc. v. Green. That case specifically addressed corporate mismanagement which resulted in the unfair treatment of subsidiary shareholders. The shareholders in Santa Fe, however, possessed all of the relevant information required for an intelligent trading decision. Santa Fe therefore differs significantly from Chiarella, in which the sellers lacked possession of all the relevant information regarding the worth of their securities. If the sellers of the target company shares had possessed the same information as Chiarella, their most intelligent action would have been to retain possession of the stock until the acquiring corporations made their tender offers at a price

128. The corporate mismanagement arose when Santa Fe attempted to acquire the stock of a subsidiary pursuant to the Delaware "short-form" merger statute. Santa Fe had offered the minority shareholders $150 per share and informed them that if that price was not satisfactory, they had the choice of obtaining an appraisal of the shares' value. Id. at 465-66. Rather than pursuing their right of appraisal, several minority shareholders sued to set aside the merger and recover the fair value of their stock, claiming that it was worth at least $772 per share. Id. at 467. The Court held that despite the significant price discrepancy, the minority shareholders had no cause of action because they had been furnished with information regarding their alternatives. Id. at 474.

129. The "intelligent investor" theory proposes that information must be disclosed according to a measurement of the effect that factual knowledge would have on the prudent or conservative investor. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848-49 (2d Cir. 1968), cert. denied, 404 U.S. 1005 (1971). See also List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965) (addressing whether reasonable person would attach importance to the information in determining his choice of action), cert. denied, 382 U.S. 811 (1965). Further, the House committee that developed the 1934 Act observed that: "No investor, no speculator, can safely buy and sell securities upon exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 11 (1934), reprinted in 5 ELLENBERGER & MAHR, supra note 1, at Item 18. See Herpick v. Wallace, 430 F.2d 792, 806 (5th Cir. 1970) (Congress intended to afford investors a reasonable opportunity to arrive at intelligent decisions).
above the prevailing market. Santa Fe, therefore, is not authority for permitting the unfairness that Chiarella practiced.

The Supreme Court disagreed with the Second Circuit's position that the federal securities laws provide a system of equal access to information for investment decisions. The Court stressed that neither Congress nor the SEC has ever adopted a "parity of information" rule and declined to do so itself. Manifesting the Court's recalcitrant attitude, it pointedly ignored an early interpretation of the fundamental philosophy of the securities acts by Representative Rayburn, Chairman of the House Committee on Interstate Commerce, under whose aegis the acts were developed. Rayburn explained that the purpose of the 1934 Act was to place buyers and sellers on the same information level so as to promote honesty and integrity in securities transactions. Adherence to such a rule would promote the primary objective of a "disclose or refrain" rule, fostering the equalization of access to material information. This policy should be placed in the forefront of judicial attacks on manipulative and deceptive schemes such as those practiced by Chiarella, because the antifraud provisions were primarily designed to prevent unfair advantages among investors. The conduct that the Court condoned in Chiarella will have a deleterious effect on the investor by making him or her prey to schemes whereby others can use nonpublic material information to their advantage and to the investor's detriment.

130. See note 13 supra.
131. 445 U.S. at 232.
132. Id. at 233. Refusing to acknowledge a parity of information rule, the majority myopically feared that such a "radical departure from the established doctrine" should not be effectuated without congressional approval. Id. The Court was unable to find support for such an extension in the language or legislative history of § 10(b). Id. at 233-34. This interpretation painfully ignored administrative statements and case law pointing towards the viability of an expansive reading of § 10(b). See notes 36, 37, 39 & 100-106 and accompanying text supra.
133. Representative Rayburn, an advocate of full disclosure of nonpublic information, noted: "The purpose of this bill is to place the owners of securities on a parity, so far as is possible, with the management of the corporations, and to place the buyer on the same plane so far as available information is concerned, with the seller." 77 Cong. Rec. 2918 (1933), reprinted in 5 Ellenberger & Mahan, supra note 1, at Item 7.
134. See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236-37 (2d Cir. 1974) (equal access rule necessary to promote integrity of national securities exchanges because transactions are anonymous); Chris-Craft Indus., Inc. v. Bangor Punta Corp., 426 F.2d 569 (1970) (Lumbard, C.J., dissenting) (fair and equal access necessary when information would be material to investor's decision); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848, 851-52 (2d Cir. 1968), cert. denied, 404 U.S. 1005 (1971) (justifiable expectation that all investors trading on impersonal securities exchanges have relatively equal access to material information); SEC v. Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961) (insider cannot use nonpublic information to which others have no access). See generally Bromberg & Lowenberg, supra note 13, § 12.2 (equalization goal of the federal securities laws stresses information and access).
135. H.R. Rep. No. 94-229, 94th Cong., 1st Sess. 91-92 (1975). The recent date of this congressional reaffirmation of the protective policy behind the antifraud laws clearly indicates Congress' preoccupation with investor protection and market integrity.
The Supreme Court's return to traditional and narrow concepts of liability for insider trading is especially significant because it strikes at the very heart of section 10(b) and rule 10b-5. Concentrating on the point at which the duty to disclose arises, the Court ignored its own admission that it is necessary to protect shareholders from insiders possessing information material to those shareholders. The Court has therefore managed to create a gap between the protective policies of the antifraud provisions of the securities laws and the vulnerable persons for whom they are intended protection. As a result, non-traditional insiders with nonpublic information may trade securities on the basis of that information and be safe from prosecution based on a defense of a lack of duty to disclose owed those claiming injuries. Though consistent with the Court's recent conservative trend, Chiarella does not fulfill the underlying philosophy of the securities laws, which are expressly designed to protect the integrity of the market. By reversing Chiarella's conviction, the majority has implicitly condoned conduct that "lies close to the heart of what the securities laws are intended to prohibit." The majority also failed to recognize that the policy favoring

136. See notes 67-75 and accompanying text supra. Justice Blackmun, dissenting in Chiarella, observed that "[t]he Court continues to pursue a course, charted in certain recent decisions, designed to transform section 10(b) from an intentionally elastic 'catchall' provision to one that catches relatively little of the misbehavior that all too often makes investment in securities a needlessly risky business for the uninitiated investor." 445 U.S. at 246 (Blackmun, J., dissenting).

137. 445 U.S. at 231-32. The Court determined that the duty to disclose arises only when a "fiduciary or similar relation of trust" exists between the parties to a transaction. Id. See text accompanying notes 93-95 supra.

138. 445 U.S. at 231-32. The majority quoted Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del.), reaff'd on later motion, 100 F. Supp. 461 (D. Del.), modified on other grounds, 235 F.2d 369 (3d Cir. 1956), for the proposition that the duty of disclosure is an attempt to provide an equalization of bargaining position so that shareholders may have the information necessary to make informed decisions in any transactions. Id. at 829. In Speed, Chief Judge Leahy noted that the fundamental purpose of the 1934 Act was to outlaw the use of inside information which worked to the detriment of uninformed public security holders. Id.

139. See, e.g., Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971) (§ 10(b) to be read flexibly, not technically and restrictively; Congress designed the statute to bar deceptive schemes); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 235 (2d Cir. 1974) (purpose behind § 10(b) and rule 10b-5 is to protect public and achieve fair dealing in securities marketplace); International Controls Corp. v. Vesco, 490 F.2d 1334, 1345 (2d Cir. 1974) ("umbrella of protection" over securities transactions intended to promote informed decision making by investors).

140. 445 U.S. at 245 (Blackmun, J., dissenting). Justice Blackmun observed that Chiarella occupied a relationship which gave him "intimate access" to nonpublic information which was intended only to be used for a corporate purpose and "not for the personal benefit of anyone." He noted that the petitioner took advantage of this nonpublic information by trading in the target company's stocks to the distinct disadvantage of the shareholders. Id. at 252. Actions such as those practiced by Chiarella harm the integrity that the securities market must maintain in order to be a viable component of the national economy.
equal access will be thwarted due to the inability to overcome advantages possessed by those, such as Chiarella, with nonpublic information. Only a liberal interpretation of section 10(b) and rule 10b-5 would foster the protection that the section and the rule are intended to provide.

Further, the majority's refusal to extend liability to "market insiders" for rule 10b-5 violations does not coincide with the Supreme Court's previous efforts to effectuate the remedial nature of the rule. The concept of "market insider" liability is premised on the fundamental notion that an individual should not be permitted to profit from using information obtained through his or her position in the securities market. The doctrine should be used to prevent those in preferred positions, such as Chiarella, from profiting based on the use of information so obtained.

The majority conspicuously left unresolved whether Chiarella's conduct might have been an actionable rule 10b-5 violation by the acquiring companies who were not parties to the transactions at issue, rather than the sellers of the target company stock. In light of Blue Chip Stamps v. Manor Drug Stores, which held that only actual purchasers or sellers possess a private cause of action under the section or the rule, the Court may be intimating a relaxation of that strict standard.

It must be noted that Chiarella's conviction was criminal rather than civil, which may to some extent explain the majority's willingness to reverse the lower court conviction. Professor Bromberg notes that criminal sanctions have not been extensive or significant even though rule 10b-5 has been held valid in a criminal context. See Bromberg & Lowenfels, supra note 13, § 10.3. Further, by the time of the Supreme Court disposition, Chiarella had made restitution of his profits to those from whom he had bought the stock.

141. See note 58 and accompanying text supra.

142. 15 U.S.C. § 78(b) (1976). That section states that the necessity for regulation of the securities market exists, inter alia, because "the prices of securities on such [national] exchanges and markets are susceptible to manipulation and control. . . ." Id.

143. See Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1973) (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963)) (securities legislation to be read "not technically and restrictively, but flexibly to effectuate its remedial purpose"). The Affiliated Ute Court applied that theory to the factual situation before it by holding that defendants Gale and Haslem engaged in market making activities, and, therefore, an extension of rule 10b-5 was warranted to reach their deceptive conduct. 406 U.S. at 150-54.

144. See Note, Rule 10b-5: Birth of the Concept of Market Insider and its Application in a Criminal Case—United States v. Chiarella, 8 FORHAM URB. L.J. 467, 476-77 (1980). The author concludes that a person who receives nonpublic market information, yet who has no relationship with the corporate source of the information, should be precluded from realizing a profit based on his or her use of that information.

145. 445 U.S. at 237-38. The Court reached no decision on this point because it claimed that the jury had not been properly charged about the elements of the duty owed to the acquiring corporation. Id. at 236. Because of the alleged improper charge, the majority stated "we will not speculate upon whether such a duty exists, whether it has been breached, or whether such a breach constitutes a violation of section 10(b)." Id.

146. 421 U.S. 723 (1975). For a more detailed discussion of the case, see notes 68-72 and accompanying text supra.

147. If such a relaxation is occurring, it appears confined to § 10(b) and rule 10b-5. Other cases suggest that the Court is narrowing the scope of implied private causes of action. In
Nevertheless, resolution of the situation presented by *Chiarella* may soon be achieved by tender offer rules recently adopted by the SEC\(^{148}\) which would impose "disclose-or-refrain" obligations on any person having knowledge of an impending tender offer. Rule 14e-3 requires that any person in possession of material nonpublic information relating to a tender offer refrain from trading in that issue unless, prior to purchase, the person publicly announces possession of that information and its source.\(^ {149}\) Recognizing the gap left open by the *Chiarella* decision, the SEC explained the basis for its new rule: "The Commission continues to believe that such conduct [trading on nonpublic information] undermines the integrity of, and investor confidence in, the securities markets, and that persons who unlawfully obtain or misappropriate material, nonpublic information violate rule 10b-5 when they trade on such information."\(^{150}\) Thus, rule 14e-3 gives the judiciary a solid foundation for forbidding manipulative and deceptive conduct.

**Alternative Theories of Liability**

The Supreme Court could have followed one of several alternate theories in resolving *Chiarella* without creating a general duty of disclosure,\(^ {151}\) all of which would have barred damaging transactions\(^ {152}\) without unduly interfering with legitimate business practices.\(^ {153}\) Among the available alternatives was

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149. *Id.* at 60,413-14.
150. *Id.* at 60,412. In its comments upon the proposed rule, the SEC expressed concern about trading on the basis of nonpublic information. It noted that such trading creates disparities in market information, promotes market disruption, and harms investors who sell their shares without the knowledge that a tender offer is imminent.
151. The majority refused to affirm *Chiarella* 's conviction fearing that to do so would impose a disclosure duty broader than that intended by Congress when it enacted the securities laws. 445 U.S. at 233.
152. The dissent observed that the Senate, in its report regarding the nature of the 1934 Act, found certain transactions to encompass "those manipulative and deceptive practices which have been demonstrated to fulfill no useful function." 445 U.S. at 241 (Burger, C.J., dissenting) (quoting S. REP. No. 782, 73d Cong., 2d Sess. 6 (1934), reprinted in 5 ELLENBERGER & MAHAR, supra note 1, at Item 17).
153. Antifraud provisions would not necessarily threaten business practices helpful to the securities market. For example, the Williams Act, 15 U.S.C. § 78m(d)(1) (1976), permits a tender offeror to purchase up to 5% of its target company's stock before disclosure of its acquisi-
the special facts doctrine.\textsuperscript{154} That doctrine recognizes that one party's superior knowledge of certain facts might have a deleterious effect on another party.\textsuperscript{155} Another theory involves quasi-insiders, recognizing that certain non-traditional insiders are in such a position in the market as to impose on them traditional insider duties.\textsuperscript{156} The misappropriation theory was another alternative open to the Court.\textsuperscript{157} Under that theory, information acquired by misappropriation is required to be divulged or retained until made public.\textsuperscript{158}

The special facts doctrine has long acknowledged that particular situations and relationships may be of such a character as to create a duty to speak; silence, therefore, violates that duty.\textsuperscript{159} Although the doctrine had its origins in the common law tort of actionable misrepresentation, it fits easily within the policy of equal access that underlies the antifraud provisions of the securities laws.\textsuperscript{160} The special facts doctrine has been adopted by courts and commentators alike. They concur that it is particularly applicable to situations involving one party's knowledge of material facts which might work an unfair advantage on another party with whom he or she is dealing.\textsuperscript{161} The usefulness of such a doctrine is illustrated in \textit{Chiarella} be-

\textsuperscript{154} \textit{See} 445 U.S. at 246 (Blackmun, J., dissenting).

\textsuperscript{155} \textit{See} Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275, 283 (2d Cir. 1975).

\textsuperscript{156} \textit{Zweig} v. \textit{Hearst Corp.}, 594 F.2d 1261 (9th Cir. 1979). \textit{Zweig} concerned a financial columnist who published a favorable article about a particular company. Before he published the article he purchased 5,000 shares of its stock. The day after the article appeared and the price had risen he sold 2,000 of his 5,000 shares, thereby recouping his initial investment and retaining the remainder of the shares for future profits. \textit{Id.} at 1264-65. The Ninth Circuit held that the columnist was a quasi-insider and that his conduct violated \$ 10(b) and rule 10b-5 just as a corporate insider would have if he or she had traded on the basis of material nonpublic information. \textit{Id.} at 1267.

\textsuperscript{157} \textit{See} 445 U.S. at 240 (Burger, C.J., dissenting).

\textsuperscript{158} \textit{Id.}

\textsuperscript{159} F. \textit{Harper} & F. \textit{James}, \textit{Law of Torts} \$ 7.14 (1956) (when facts in possession of one party are not available to other party, failure to disclose may be active concealment and actionable).

\textsuperscript{160} In \textit{SEC} v. \textit{Texas Gulf Sulphur Co.}, 401 F.2d 833, 848 (2d Cir. 1968), \textit{cert. denied}, 404 U.S. 1005 (1971), the court specifically referred to the special facts doctrine as a source for rule 10b-5. Explaining that the purpose of rule 10b-5 was to promote confidence in the market and equal access to material information, the court found that misuse of special facts stymied these goals.

\textsuperscript{161} \textit{Lewelling} v. \textit{First Cal. Co.}, 564 F.2d 1277, 1280 (9th Cir. 1977) (rule 10b-5 requires those possessing material information not available to other party to disclose it or refrain from trading; total silence in the face of this duty is actionable); \textit{United States v. Charnay}, 537 F.2d 341, 348-50 (9th Cir.) (language of rule 10b-5 does not mean only insiders; rather, it applies to anyone with material information), \textit{cert. denied}, 429 U.S. 1000 (1976); \textit{SEC v. Texas Gulf Sulphur Co.}, 401 F.2d 833, 848 (2d Cir. 1968) (use of special facts may violate policy of rule 10b-5), \textit{cert. denied}, 404 U.S. 1005 (1971); \textit{List v. Fashion Park Inc.}, 340 F.2d 457, 461-62 (2d Cir. 1964) (rule 10b-5 as stringent as common law rule that there can be fraud even though perfect silence was kept), \textit{cert. denied}, 382 U.S. 811 (1965); \textit{Speed v. Transamerica Corp.}, 99
cause the sellers of the target company were prevented from realizing the profits that Chiarella did. Such conduct fits well within the protective features of the special facts doctrine.

The Court also could also have chosen to adopt the quasi-insider theory. This theory postulates that certain individuals, occupying a preferred position in the securities market, may acquire nonpublic information to the disadvantage of others. The Second Circuit found that the quasi-insider category was nearly analogous to the market insider category that it had suggested as a premise upon which rule 10b-5 liability could be based, and

F. Supp. 808, 829 (D. Del.), reaff’d on later motions, 100 F. Supp. 461 (D. Del. 1951), modified on other grounds, 235 F.2d 369 (3d Cir. 1956) (duty to disclose may be premised on special circumstances); Lingsch v. Savage, 213 Cal. App. 2d 729, 735, 29 Cal. Rptr. 201, 204 (1963) (duty to disclose imposed where one party in possession of facts not known to the other); Jones v. Arnold, 359 Mo. 161, 169, 221 S.W.2d 187, 194 (1949) (duty to disclose arises where facts are not within fair reach of other party). See 3 L. Loss, SECURITIES REGULATIONS 1445 (2d ed. 1961). Professor Loss observed that rule 10b-5 applies whenever any person, insider or outsider, engages in “fraudulent practices” in securities transactions. See also Fleischer, Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding, 51 Va. L. Rev. 1271 (1965). Fleischer suggested that the duty to disclose arises in those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if disclosed.” Id. at 1289.

In his dissent in Chiarella, Justice Blackman noted: “[A]ccess to ‘special facts’ has been a recurrent theme in administrative and judicial application of rule 10b-5 to insider trading. Both the SEC and the courts have stressed the insider’s misuse of secret knowledge as the gravaman of illegal conduct. The Court, I think, unduly minimizes this aspect of prior decisions.” 445 U.S. at 249 (Blackmun, J., dissenting).

162. The quasi-insider theory was first articulated in the American Law Institute’s Federal Securities Code, which partially codifies rule 10b-5 (in § 1602) and prohibits insider trading (in § 1603). ALI FED. SECURITIES CODE §§ 1602, 1603 (1980) [hereinafter cited as ALI CODE]. Under the Institute’s definition, quasi-insiders would include judges’ clerks who trade on information in unpublished opinions, bank employees trading on undisclosed knowledge of interest rate changes and printers who trade on undisclosed knowledge of imminent tender offers (citing United States v. Chiarella, 588 F.2d 1358 (2d Cir. 1978), cert. granted, 441 U.S. 942 (1979)). ALI CODE, supra, § 1603, Comment (d). Further, the comment indicates that if conduct sufficiently “egregious, shocking, or offensive” cannot be rationalized on an insider analysis, a plaintiff may rely upon the broad provisions of § 1602(a)(1) which state in pertinent part: “(a) It is unlawful for any person to engage in a fraudulent act or to make a misrepresentation in connection with (1) a sale or purchase of a security...” Id. The Second Circuit found Chiarella’s conduct to be sufficiently egregious “to fit the most restrictive definition of a quasi-insider” and that he should be barred from trading under § 1602. 588 F.2d at 1366. Chief Justice Burger, in his dissent, argued that the quasi-insider theory supported his position that when an informational advantage is gained by deceptive practices made possible through one’s position in the market, the conduct is violative of § 10(b) and rule 10b-5. 445 U.S. at 240 (Burger, C.J., dissenting). The majority, however, conspicuously ignored the quasi-insider theory. Utilizing a better reasoned analysis, the Court would have deemed Chiarella an insider under § 1603(b)(3) of the ALI CODE, which provides that an insider is one “whose relationship or former relationship to the issuer gives or gave him access to a fact of special significance... not generally available.” ALI CODE, supra, § 1603(b)(3). Such a finding would have effectively connected the Institute’s quasi-insider theory with the special facts doctrine because Chiarella’s relationship with the offeror companies, through his employment with Pandick, afforded him access to facts of special significance.

163. 588 F.2d at 1365.
completed its well-reasoned decision by coupling the quasi-insider theory with a test that found that those with "regular access to market information" should come under the proscriptions of rule 10b-5. The Court, however, established that the regular access test espoused by the Second Circuit was insufficient to support a duty to disclose nonpublic information. The duty, according to the majority, arose out of the "relationship between the parties," rather than the source of the information. The narrow view taken by the majority regarding the quasi-insider theory indicates its neglect of the broad purposes and remedial nature of the antifraud laws.

A third theory upon which Chiarella's liability could have been premised was the misappropriation theory announced by Chief Justice Burger. He argued that an absolute duty to disclose information arises when a person misappropriates nonpublic information. The Chief Justice adopted that theory to recognize that the general rule allowing nondisclosure of information in an arm's length transaction must give way when an informational advantage is obtained by illegal means. The misappropriation theory is a particularly attractive vehicle when the policies underlying the antifraud securities laws are considered. Enforcement of section 10(b) and rule 10b-5, grounded on a broad interpretation of "misappropriation," buttresses the purpose and policies of the antifraud laws because it attacks the very conduct Congress sought to proscribe—those manipulative and deceptive devices that undermine investor confidence in the securities market. Further, the misappropriation theory would clarify the scope of the section and rule when read in conjunction with Affiliated Ute Citizens v. United States. In that case, the Court emphasized that section 10(b) and rule 10b-5 "by repeated use of the word 'any' are obviously meant to be inclusive." Construing the theory to apply to "any" person would identify the class of potential violators, thereby providing adequate notice to traders in the securities markets and satisfying the doubts of the majority who feared the creation of a general rule of disclosure. Applying such a reading in Chiarella would have allowed the majority to affirm his conviction based upon precedent and policy.

164. Id. at 1365-66.
165. 445 U.S. at 231 n.14.
166. Id.
167. Id. at 240 (Burger, C.J., dissenting).
168. As long as one party does not actively mislead another he may be free to take advantage of facts that his business acumen can bring him. W. PROSSER, LAW OF TORTS § 106 (4th ed. 1971).
169. 445 U.S. at 240. The Chief Justice recognized Professor Keeton's comment: "Any time information is acquired by an illegal act it would seem that there should be a duty to disclose that information." Id. (quoting Keeton, Fraud—Concealment and Non-Disclosure, 15 TEX. L. REV. 1, 25-26 (1936)).
170. See notes 103-106 and accompanying text supra.
172. Id. at 151.
Chiarella is the Supreme Court’s latest decision in a series of holdings that have the effect of thwarting the protective policies underlying the anti-fraud securities laws. The majority has given notice to the securities market that section 10(b) and rule 10b-5 liability are grounded upon a duty that originates from a relationship of trust and confidence. The Court’s ruling ignores the effects of Chiarella’s conduct by utilizing a narrow interpretation of the section and rule, a construction contrary to the principles manifested by its legislative and judicial history. The restrictive holding fosters manipulative and deceptive practices that harm the integrity of the securities marketplace. As a result of the holding, it is difficult to predict the fate of those investors for whom protection was intended. Perhaps the recently adopted SEC tender offer rules will at last create the shield that must hold firm if equitable trading in securities is to be fostered.

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