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Gary Bunch

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Chiarella: The Need for Equal Access Under Section 10 (b)

GARY BUNCH*

This article examines the Second Circuit's landmark Chiarella opinion. The author concludes that the United States Supreme Court erred in reversing the court of appeals. Rather, the Court should have held that Chiarella's purchases of securities on the basis of nonpublic material market information constituted fraud in violation of Section 10(b) and Rule 10b-5. A rule of law should have been established that a person who possesses nonpublic material market information and engages in purchases or sales of securities on the basis of that information without disclosing the information to the investing public violates Section 10(b) and Rule 10b-5. The only exception should be for the person who is fulfilling an essential market function or who is a tender offeror.**

United States v. Chiarella,† is the first criminal prosecution under Section 10(b) of the Securities Exchange Act of 1934‡ and

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* Assistant Professor of Law and Public Policy, Syracuse University. B.G.S., University of Kentucky, 1973; M.A., University of Wisconsin-Madison, 1974; J.D., Emory University School of Law, 1976; LL.M., New York University School of Law, 1979.

** This article was accepted for publication prior to the Supreme Court's decision in the case. The author believes that the interpretation of Section 10(b) and Rule 10b-5 presented in this article is consistent with principles enunciated by the Supreme Court, the lower federal courts and the SEC, and that the Supreme Court's decision, which undermines the purpose and policy of the section and rule, merits review by Congress.

† 588 F.2d 1358 (2d Cir. 1978), rev'd, 100 S. Ct. 1108 (1980).

‡ Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976) provides:

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

. . . .
Rule 10b-5\textsuperscript{3} thereunder. The United States Second Circuit Court of Appeals affirmed Vincent Chiarella's conviction for purchasing stock of five companies on the basis of material nonpublic information that these companies were about to be targets of tender offers,\textsuperscript{4} information which he did not disclose to the investing public. The case presents novel aspects and portends the opening of a new era in Section 10(b) and Rule 10b-5 litigation. Chiarella was not an insider,\textsuperscript{5} officer, director, large shareholder or an em-

(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. 17 C.F.R. § 240.10b-5 (1979). The SEC promulgated Rule 10b-5 which has become the predominant antifraud provision in the federal securities law, under the authority of Section 10(b) of the 1934 Act. Rule 10b-5 states:

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

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

Milton V. Freeman, now a partner in the Washington, D.C. law firm of Arnold & Porter, describes the Commission's adoption of Rule 10b-5 as follows:

It was one day in the year 1943 [1942], 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 S.E.C. Regional Administrator in Boston, "and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at $4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be $2.00 a share for this coming year. Is there anything we can do about it?" So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17, and I put them together and the only discussion we had there was where "in connection with the purchase or sale" should be, and we decided it should be at the end.

We called the Commission and 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?"

Freeman, Administrative Procedure, 22 BUS. LAW. 891, 922 (1967).

4. In conventional tender offers the offeror typically offers to purchase all or a portion of a company's shares at a premium price, the offer to remain open for a limited time. Frequently, the obligation to purchase on the part of the offeror is conditioned on the aggregate number of shares tendered; the offeror need not purchase the excess; if less than a certain number are tendered the offeror need not purchase any. The shareholder responding to the offer generally must relinquish control of the shares he desires to tender until the response of others is determined. H.R. REP. NO. 1711 90th Cong., 2d Sess. 2 (1967).

ployee who learned of material information of the companies whose securities he purchased. Nor was he a tippee of such an insider, that is, a person entrusted with material information before that information has been made public. Moreover, Chiarella traded on nonpublic market information, information dealing with circumstances affecting the demand for the company's securities but not necessarily reflecting on the ability of the company's underlying assets to generate a stream of income. Furthermore, the information originated and emanated from sources other than the companies whose securities he purchased. Thus a nexus did not exist between either Chiarella and the issuer corporations or the material nonpublic information and the issuer corporations.

The Supreme Court granted certiorari and its decision could clarify an important question presented by the SEC in 1973: "Whether and to what extent selected, nonpublic knowledge about the existence of future markets in particular securities should be treated as material information which must be disclosed by security professionals or other persons prior to any transaction in the securities." Inherent in the Commission's question is whether Section 10(b) and Rule 10b-5 require equal access to material information among purchasers and sellers of securities.

Section 1603: "Insider" means (1) the issuer, (2) a director or officer of, or a person controlling, controlled by, or under common control with the issuer, (3) a person whose relationship or former relationship to the issuer gives or gave him access to a fact of special significance about the issuer or the security that is not generally available, or (4) a person who learns such a fact from a person specified in Section 1603(b) . . . with knowledge that the person from whom he learns the fact is such a person. . . .

6. In Faberge, Inc. the Commission addressed the question when information was available to the investing public. The Commission said:

In order to effect a meaningful public disclosure of corporate information, it must be disseminated in a manner calculated to reach the securities market place in general through recognized channels of distribution, and public investors must be afforded a reasonable waiting period to react to the information. Obviously, what constitutes a reasonable waiting period must be dictated by such surrounding circumstances as the form of dissemination and the complexity of the information, i.e., whether it is "readily translatable into investment action". . . . Proper and adequate disclosure . . . can only be effected by a public release through the appropriate public media, designed to achieve a broad dissemination to the investing public generally and without favoring any special person or group.


After reviewing the facts of the case and the Second Circuit Court of Appeals’ opinion, this article will examine Chiarella’s purchases under traditional Section 10(b) and Rule 10b-5 analysis and then explore the novel questions presented by his purchases. The author will present an argument that Section 10(b) and Rule 10b-5 require equal access to material information among purchasers and sellers of securities, and that Chiarella’s failure to disclose the impending tender offers while making purchases of the prospective target companies’ securities violated the Section and the Rule because he used information not available to the investing public.

FACTS OF THE CASE

Chiarella was a markup man in the composing room at Pandick Press, a Manhattan printing firm engaged in financial, corporate, legal and general printing. Pandick often printed prospectuses, registration statements and offering circulars. Chiarella’s responsibility as markup man included choosing the type fonts and page layout for customers’ manuscript copy.

The federal securities laws require a company making a tender offer for the stock of another company to file a statement disclosing pertinent information, with the Commission.9 A company preparing to engage in a tender offer, in order to protect the confidentiality10 of its plan, gives the documents to the printing

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9. At the time of Chiarella’s purchases § 14(d)(1) of the 1934 Act and Rule 14b-1 pursuant thereto, mandated that an offeror file a schedule 13(D) with the SEC when the offer was first published or sent or given to security holders of the target company. Schedule 13(D) requires provision of the following information: (1) title of the class of equity security to which the schedule relates and the name and address of the issuer; (2) identity and background of the person filing the schedule; (3) source and amount of funds or other consideration to be used in making the purchases; (4) the purpose or purposes of the offer must be described; (5) the number of shares of the target company beneficially owned, and the number of shares which the offeror or his associate have the right to acquire, directly or indirectly, giving the name and address of any such associate and information as to transactions in the shares during the past sixty days by the offeror and by its subsidiaries and the officers, directors and affiliated persons; (6) information as to any contracts or arrangements concerning securities of the target company such as joint ventures, loans, options, puts or calls, guarantees, divisions of losses or profits, furnishing the details and names of the parties to such an agreement; (7) the identity of all persons and classes of persons employed, retained or to be compensated by the offeror to make solicitations or recommendations in connection with the offer and a brief description of the term of any agreement between them. Exhibits to the schedule must include all soliciting material.

10. Obviously, a company intending to make a tender offer strives to keep its plan secret. If word of the impending offer becomes public, the price of the stock will rise toward the expected tender price. Thus, the primary inducement to stockholders, an offer to purchase their shares at an attractive price above the market, is lost, and the offeror may be forced to
firm with the identity of the company whose stock is to be acquired left blank or coded. Immediately before the filing of the documents with the Commission the identity of the target company is given to the printing firm who then prints a final copy of the documents.

Although the targets' identities were left blank or coded, the job copy sent to Pandick contained details of the proposed tender offer and certain other information such as price histories and par values from which the identity of the target companies could be ascertained. Five times during 1975 and 1976 Chiarella, "not merely an ordinary printer, but a knowledgable stock trader who spoke with his broker as often as ten or fifteen times a day," decoded tender offer documents which Pandick Press was preparing for clients. After deciphering the identity of the target companies, Chiarella purchased stock of the companies in open market trading before the tender offer documents were filed with the Commission. Chiarella then sold the stock after the tender offers were announced to the investing public, realizing a profit of

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...[I]n spite of all precautions, there have been cases where tender offers have been preceded by leaks and rumors which caused abnormal market problems.

Full disclosure of Equity Ownership and in Corporate Takeover Bids: Hearings on § 510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess. 72 (1967) (testimony of Donald Calvin, Vice President of the New York Stock Exchange).

11. "[W]hen Emhart Corp. sought to purchase control of USM Corp., the documents originally delivered to Pandick read 'Arabia Corp.' and 'USA Corp.' Not until the final press run on the night before release were the true names inserted." United States v. Chiarella, 588 F.2d 1358, 1363 (2d Cir. 1978), rev'd, 100 S. Ct. 1108 (1980).

12. Id.

13. Chiarella entered into 17 purchase transactions for the stock of the target companies. Each purchase was charged as a separate count in his indictment and he was convicted on each count. Chiarella was prosecuted under the authority of § 32 of the Securities Exchange Act of 1934, 15 U.S.C. § 78ff (1976), which provides in pertinent part:

(a) Any person who willfully violates any provision of this chapter, or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter shall upon conviction be fined not more than $10,000, or imprisoned not more than five years, or both... but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.
$30,011.39. Chiarella did not disclose to the investing public the material nonpublic information that he possessed concerning the impending tender offers for the stock of the five companies whose stock he purchased. Furthermore, none of the persons from whom Chiarella purchased shares of the corporation were aware of the impending tender offer for the stock they owned.

THE COURT OF APPEALS' OPINION

In upholding Chiarella’s conviction for violating Section 10(b) and Rule 10b-5, the Second Circuit Court of Appeals interpreted the section and rule as provisions aimed at “conduct that destroyed confidence in the securities markets” and in particular “those manipulative and deceptive practices which have been demonstrated to fulfill no useful function.” The court thought it “difficult to imagine conduct less useful, or more destructive of public confidence in the integrity of our securities markets, than Chiarella’s.”

The court declared that Chiarella, in purchasing the securities of the companies about to be targets of tender offers, breached his duty as an agent of the offeror corporation by “convert[ing] to his personal use confidential information entrusted to him in the course of his employment.” Chiarella’s misuse of the converted information by purchasing the target companies’ securities could have aborted the impending tender offers by triggering “an antici-

14. Chiarella’s transactions broke down as follows:

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<tr>
<th>PURCHASES</th>
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<tr>
<td>TARGET</td>
</tr>
<tr>
<td>USM.......</td>
</tr>
<tr>
<td>Riviana Foods (Merger)</td>
</tr>
<tr>
<td>Foodtown Stores ....</td>
</tr>
<tr>
<td>Booth Newspapers...</td>
</tr>
<tr>
<td>Sprague Electric .....</td>
</tr>
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TOTAL PROFIT $30,011.39

United States v. Chiarella, 588 F.2d 1358, 1363 n.3 (2d Cir. 1978), rev’d, 100 S. Ct. 1108 (1980).

15. Id. at 1368.
16. Id. at 1368-69.
17. Id. at 1368.
18. Id. at 1367-68.
patory rise in the market price of the target company's stock."\textsuperscript{19} In an important footnote the court stated that Chiarella's misuse of confidential information constituted a fraud in violation of Section 10(b) and Rule 10b-5 on the companies engaging in the tender offers.

The indictment fairly charges Chiarella violated [Section 10(b) and] Rule 10b-5 by converting offerors' confidential information to his own use. . . . Clearly, violation of an agent's duty to respect client confidences, Restatement [\textit{2d}] Agency Section 395, transgresses Rule 10b-5 where, as here, the converted information both concerned securities and was used to purchase . . . securities.\textsuperscript{20}

However, the court did not focus on Chiarella's violation of a duty to the tender offerors, but rather rested its decision on Chiarella's abuse of his nexus to the securities market which provided him regular access to material nonpublic information. The court noted that the fact Chiarella was "not an insider of the companies whose securities he traded [was] irrelevant,"\textsuperscript{21} since a "financial printer such as Chiarella is as inside the market itself as one could be."\textsuperscript{22}

The court stressed the "strategic place in the market mechanism"\textsuperscript{23} occupied by Chiarella, since financial printers are "central, though generally unheralded cog[s] in the vital machinery

\textsuperscript{19}. Id. at 1363.
\textsuperscript{20}. Id. at 1368. The district court, in denying Chiarella's motion to dismiss the indictment, stated the indictment charged that Chiarella's purchasing stocks by converting the prospective tender offerors' material nonpublic information constituted a fraud on those corporations.

Crediting the indictment, there is no question that Chiarella wrongfully took corporate information—unquestionably material and non-public—entrusted to him by offering corporations, and used it solely for personal profit, which information was "intended to be available only for a corporate purpose and not for the benefit of anyone." . . . The analogy of embezzlement by a bank employee immediately springs to mind, and, of course, embezzlement implies fraudulent conduct. \textit{E.g.}, Grin v. Shine, 187 U.S. 181, 189-90 (1902). . . . Chiarella can, therefore, hardly claim that the acts alleged did not operate as a fraud. . . . Chiarella's purchases further operated as a fraud upon the acquiring corporations whose plans and information he took while he was setting them in type, because his purchases might possibly have raised the price of the target companies' stock, increasing the cost of legitimate market purchases by such acquiring corporations, and thus constituted 'a manipulative or deceptive device or contrivance' within the prohibition of \textsection 10(b) and Rule 10b-5."


\textsuperscript{21}. 588 F.2d at 1364.
\textsuperscript{22}. Id.
\textsuperscript{23}. Id. at 1365.
for disseminating information to investors."24 who regularly receive material nonpublic information. The court declared that Chiarella must be "forbidden to reap personal gain from information received by virtue of [his] position."25 The court emphasized that "all investors trading on impersonal exchanges [should] have relatively equal access to material information,"26 and held that "[a]nyone—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose. And if he cannot disclose, he must abstain from buying or selling."27

Judge Meskill dissented, stating that, since prior cases imposing Section 10(b) and Rule 10b-5 on persons purchasing or selling securities on material nonpublic information have relied upon that person occupying a special relationship with the corporation whose securities were purchased or sold, Chiarella did not owe a "duty of disclosure to the sellers of target stock."28 Judge Meskill viewed the court's decision as "a departure from prior law"29 since the decision "expands § 10(b) drastically, [and] it does so without clear indication in prior law that this is the next logical step on the path of judicial development of § 10(b)."30

TRADITIONAL ANALYSIS

*Cady, Roberts & Co.*31 is the landmark SEC interpretation of Section 10(b) and Rule 10b-5 in connection with securities transactions based on nondisclosure of material nonpublic information by parties engaged in open market trading. In 1959 the price of Curtiss-Wright corporate securities had been rising as a result of an announcement of a new product. However, when the board of directors of Curtiss-Wright met on November 25, 1959, they decided to reduce Curtiss-Wright's dividend in the fourth quarter to 0.375 dollar per share from a 0.625 dollar per share declared and paid in the previous three quarters.

Mr. Cowdin, a board member of Curtiss-Wright and a member of Cady, Roberts and Co., a broker dealer firm registered with the Commission under the 1934 Act, informed Mr. Gintel, a partner in the Cady, Roberts firm, of Curtiss-Wright's dividend reduction.

24. *Id.*
25. *Id.*
26. *Id.*
27. *Id.*
28. *Id.* at 1375.
29. *Id.* at 1373.
30. *Id.*
Mr. Gintel in early November had purchased approximately 11,000 shares of Curtiss-Wright stock for discretionary accounts. Mr. Gintel, before the Curtiss-Wright dividend reduction was announced to the investing public, sold 2,000 shares of Curtiss-Wright stock and entered into short sales of 5,000 shares of their stock. When the investing public learned of Curtiss-Wright’s dividend reduction the price of the stock fell sharply.

Since the case was “one of first impression and one of signal importance in [the Commission’s] administration of the Federal Securities Act,” the Commission elaborately enunciated the legal principles of Section 10(b) and Rule 10b-5. The Commission stated that the antifraud provisions are “phrased in terms of ‘any person’ and that a special obligation has been traditionally required of corporate insiders, e.g., officers, directors and controlling stockholders.” However, the Commission stressed that these three groups “do not exhaust the classes of persons upon whom there is such an obligation.” The Commission stated: “Our task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities.” The Commission proceeded to establish a two pronged access fairness standard for determining, under Section 10(b) and Rule 10b-5, when purchasers and sellers of securities have a duty to disclose material nonpublic information:

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

32. Short selling is the borrowing of stock, reselling it, and then repurchasing the stock later so that the stock may be returned. The economic gain, if any, is the difference between the sale price and the repurchase price.
33. 40 S.E.C. at 907.
34. Id. at 912.
35. Id.
36. Id.
37. Id. The Commission had earlier indicated that tippees, which Gintel could be viewed as, were not liable under Section 10(b) and Rule 10b-5 for trading on the basis of material nonpublic information. A representative of the Commission testified before a Congressional Committee in 1952 as follows:

Mr. Byrne: [The members of the Commission] agree 100 percent that an insider cannot take advantage of a stockholder of his company in connection with the purchase from him or the sale to him of the company’s stock where he has information not known to that man on the other side of the
In *SEC v. Texas Gulf Sulphur Co.* the United States Second Circuit Court of Appeals, in a seminal Section 10(b) and Rule 10b-5 decision, adhered to the principles announced by the Commission in *Cady, Roberts*. The Texas Gulf Sulphur Company made a significant mineral discovery on property it owned near Timmins, Ontario. Visual estimation and follow-up chemical assays of the ore content of initial test holes revealed extraordinarily high mineral content. The company ceased drilling for several months so that it could acquire the land around the test site. During this period company officers, employees and persons to whom they had provided information about the mineral discovery purchased Texas Gulf Sulphur stock in open market trading without disclosing to the investing public the potentially significant discovery.

Texas Gulf Sulphur withheld public disclosure of their preliminary test findings until rumors of the company’s mineral discovery surfaced and were given prominent attention in the press. Texas Gulf Sulphur then released a press announcement stating

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transaction because of his fiduciary obligation to disclose it to him. I do not believe, however, the Commission takes the second and third steps. . . . I mean this: That insider could communicate to an outsider the same information he knows, and the outsider might act on it, and unless the Commission had evidence from which they could conclude that the insider was a party in fact to the transaction, either acted in concert with or conspiracy with the outsider, I do not think that they would hold the outsider as being in violation of [Rule 10b-5], and your third case is what I call the locker-room case . . . where a fellow at the golf club overhears the insider talking to a friend of his, and he himself acts on the basis of the information he heard, and [in] that case I do not think the Commission would touch it at all at this stage of its existence.

Mr. Heller: Would they hold the insider?
Mr. Byrne: They would hold the insider without question in the first case; in the second and third cases, they would not hold the outsider who had the inside information unless they could show a conspiracy or a concert of action with the insider in which event they would hold as to both of them, and in no event would they hold the locker-room man.

*Study of the Securities and Exchange Commission: Hearings Before the Subcomm. of the House Comm. on Interstate and Foreign Commerce, 82d Cong., 2d Sess., 725-26 n.1 (1952) (statement of Peter T. Byrne, Director of Trading and Exchange).*

In analyzing the Wall Street financial community’s reaction to the Commission’s *Cady, Roberts* decision, a commentator has stated:

But so firmly entrenched was the Wall Street tradition of taking unfair advantage of the larger investing public, and so lax the S.E.C.’s administration of that particular part of the law between 1942 and 1961, that not a single stockbroker had ever been prosecuted for improper use of privileged information during those two decades. In the tarpaper shack, 10b-5 had simply been considered too hot to handle. It was the law in name only. . . . [Following the *Cady, Roberts* decision it was believed that] presumably the agency would pursue the new policy in the future. . . . [Criticism flowed from the Wall Street financial community] [b]ut soon the grumbling died down, and the Stock Exchange turned around and issued a strong set of new directives to its members against the use of inside information by brokers.


the rumors were exaggerated as the company needed to engage in more extensive drilling before the significance of their findings could be accurately assessed. Four days after this press announcement, Texas Gulf Sulphur disclosed to the investing public that the company had made a significant mineral discovery. Before this announcement was disseminated to the investing public, company officers and employees, without disclosing the mineral discovery, made further purchases of Texas Gulf Sulphur stock in open market trading.

The Court of Appeals for the Second Circuit, in holding that these purchases of Texas Gulf Sulphur stock violated Section 10(b) and Rule 10b-5, articulated a “possession” test: “[A]nyone in possession of material inside information must either disclose it to the investing public, or if he is disabled from disclosing . . . or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.”

In the other leading Section 10(b) and Rule 10b-5 case, Investors Management Co., the Commission expanded the standard announced in Cady, Roberts. Douglas, a leading manufacturer of commercial airplanes, informed Merrill, Lynch, Pierce, Fenner & Smith, the managing underwriter in a prospective Douglas debenture issue, that its earnings for the current year would be significantly less than previously forecast. Douglas, who had forecasted earnings of eight to twelve dollars per share for 1967, revealed to Merrill Lynch that new information indicated no earnings for Douglas in 1966 and only approximately half the original forecast for 1967. The underwriting department of Merrill Lynch passed the revised Douglas earnings information to members of the Merrill Lynch sales department, who on June 21, 1966, gave the information to representatives of major institutional clients. These institutions between June 21st and June 23rd sold 133,400 shares and entered into short sales of 21,400 shares of Douglas stock in transactions totalling over $13,300,000 before the company’s revised earning estimates were disclosed to the investing public. The Commission held that these sales of Douglas securities violated Section 10(b) and Rule 10b-5 since anyone possessing material nonpublic information: “which he has reason to know

39. Id. at 848.
40. 44 S.E.C. 633 (1971).
emanates from a corporate source, and which by itself places him in a position superior to other investors, thereby acquires a relationship with respect to that information within the purview and restraints of the antifraud provisions." Thus, the Commission dropped the *Cady, Roberts* requirement of a special relationship giving access to material nonpublic information and held that a mere reason to know that one possesses material nonpublic information places one within the ambit of Section 10(b) and Rule 10b-5.

In accordance with these cases the United States Supreme Court has pronounced that Section 10(b) and Rule 10b-5 prohibit trading on the basis of material nonpublic information. In *Foremost-McKesson, Inc. v. Provident Securities Co.* the Court stated: "Congress has passed general antifraud statutes that proscribe fraudulent practices by insiders. [Citations]. Today an investor who can show harm from the misuse of material inside information may have recourse, in particular, to §10(b) and Rule 10b-5. . ."

The *Cady, Roberts* two pronged access fairness test, the most restrictive test announced in the three leading Section 10(b) and Rule 10b-5 cases, is met in the *Chiarella* case. Chiarella's employment as a printer provided him access to material nonpublic information intended to be used only for the tender offerors' corporate purposes and not by Chiarella for his personal gain. Second, the material information known by Chiarella of the impending tender offers was undisclosed to the investing public. Chiarella was disabled from disclosing the information to protect the corporate confidences of his employer's clients, the companies about to engage in tender offers. The fact that the information was available to Chiarella but not to the persons from whom he purchased securities makes his transactions inherently unfair.

However, the argument may be presented that the novel aspects of Chiarella's case—that he was neither an insider of the company whose stock he purchased nor the tippee of such insider, and the fact that he traded on market information, makes Section 10(b) and Rule 10b-5 inapplicable to his purchases. The remainder of this article will focus on these issues and the larger

41. The Commission stated:

[T]he question of whether the recipient had the requisite 'reason to know' is properly determinable by an examination of all the surrounding circumstances, including the nature and timing of the information, the manner in which it was obtained, the facts relating to the informant, including his business or other relations to the recipient and to the source of his information, and the recipient's sophistication and knowledge of related facts.

*Id.* at 644.

issue of whether Section 10(b) and Rule 10b-5 require equal access to material information among purchasers and sellers of securities, at least when equal access would not interfere with the effectiveness of the security market.

**Is Rule 10b-5 Limited to Insiders in Nondisclosure Cases?**

In analyzing the scope of Section 10(b) and Rule 10b-5 "our analysis must begin with the language of the statute itself." Section 10(b) forbids "any person" "directly or indirectly" to "use or employ in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules . . . as the Commission may proscribe . . . for the protection of investors." Rule 10b-5, promulgated by the Commission pursuant to authority granted by Section 10(b), prohibits "any person" from using "any device, scheme or artifice to defraud" or from "engag[ing] in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person" in connection with a purchase or sale of securities. The Supreme Court, in *Affiliated Ute Citizens of Utah v. United States*, recognized that "[t]hese proscriptions, by statute and rule, are broad and, by repeated use of the word ‘any’ are obviously meant to be inclusive."

The court in *Texas Gulf Sulphur* mentioned "traditional fiduciary concepts" and the "special facts doctrine." These principles, developed by courts in common law tort cases dealing with fraud by silence, state that a tort action for fraud exists when one party to a transaction withholds material information which the other person is entitled to know due to a fiduciary or special relationship of trust between them. The court could have used such

43. In *Cady, Roberts & Co.*, the Commission stated that "misrepresentations will lie within [the] ambit [of § 10(b) and Rule 10b-5] no matter who the speaker may be," 40 S.E.C. at 911.


Just as a trustee has no right to retain for himself the profits yielded by property placed in his possession but must account to his beneficiaries, a corporate fiduciary, who is entrusted with potentially valuable information, may not appropriate that asset for his own use. . . . [T]here can be no justification for permitting officers and directors . . . to retain . . . profits which . . . they derived solely from exploiting information gained by virtue of their inside position as corporate officials.
reasoning to limit the prohibitions of Section 10(b) and Rule 10b-5 to insiders. However, the court stated that the section and rule apply to persons other than those labeled insiders. The court stressed that:

[The essence of Section 10b and Rule 10b-5] is that anyone who, trading for his own account in the securities of a corporation, has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," i.e., the investing public. . . . Insiders, as directors or management officers, are of course, by this Rule, precluded from so unfairly dealing, but the Rule is also applicable to one possessing the information who may not be strictly termed an "insider."47

In Investors Management, the Commission could have decided the case under traditional insider analysis. Merrill Lynch, as managing underwriter for a prospective Douglas debenture issue, in performing the statutorily required investigation of the issuer, received from Douglas "information intended to be available only for a corporate purpose and not for the personal benefit of anyone."48 The Commission could have reasoned that Merrill Lynch had a special relationship of trust with Douglas as underwriter and had breached their duty in violation of Section 10(b) and Rule 10b-5 in disclosing the material nonpublic information to some of their institutional clients with the understanding that the clients would sell Douglas stock on the basis of the material nonpublic information. Under this type of analysis the institutions that sold Douglas stock could have been viewed as tippees of insiders.49

However, the Commission did not engage in that type of analysis and instead held that the appropriate test for Section 10(b) and Rule 10b-5 was whether a person "knew or had reason to know that the information was non-public and had been obtained improperly by selective revelation or otherwise."50 The Commission's test for Section 10(b) and Rule 10b-5 liability does not depend upon the nature of the relationship between the person purchasing or selling securities and the issuers of those securities. The Commission "reject[ed] the contentions advanced by the respondents that no violation can be found unless it is shown that the recipient himself occupied a special relationship with the issuer or insider corporate source giving him access to the non-public information. . . ."51

47. SEC v. Texas Gulf Sulphur Co., 401 F.2d at 848.
49. Note that liability under this approach, rejected by the Commission, depends upon the relationship between the seller and the issuer of the stock.
51. Id. at 643-44.
“Neither [Section 10(b) nor Rule 10b-5] . . . establish artificial walls of responsibility” which make their prohibition applicable only to insiders or tippees of such insiders. Thus, their provisions should apply to people like Chiarella as well as to insiders of the issuer corporation who purchase securities based on material nonpublic information. Although the purchaser or seller of securities receives the information from different sources, their situations are analogous. The material information is unavailable to the investing public and the information was generated for a corporate purpose and not for the personal gain of the person trading on it.

Congress, in enacting Section 10(b), and the Commission, in promulgating Rule 10b-5, "did not limit [themselves] to protecting shareholders from the speculations of their officers and directors." A holding requiring a fiduciary or a special relationship between the person purchasing or selling securities on the basis of material nonpublic information and the company whose stock is purchased or sold would shield from Section 10(b) and Rule 10b-5 liability persons such as accountants, bankers, lawyers, stockbrokers, and others who obtain material nonpublic information and then use that information to purchase or sell securities. Furthermore, the sale of the information by such persons would be immune from the sanction of Section 10(b) and Rule 10b-5. As the court in Chiarella noted, “[i]t is difficult to imagine conduct less useful, or more destructive of public confidence in the integ-

53. United States v. Chiarella, 588 F.2d at 1365.

In Zvieg v. Hearst Corp., 594 F.2d 1261 (9th Cir. 1979) the plaintiffs were the owners of a corporation that entered into a merger agreement with American Systems Inc. (ASI). The contract stated that the plaintiffs would receive shares of ASI in consideration for transferring their corporation to ASI. The amount of ASI shares to be received by plaintiffs was tied to the market price of ASI stock at the closing. The defendant, Alex A. Campbell, a widely read financial columnist, encouraged his readers to purchase ASI. The plaintiffs claimed that the directors of ASI induced Campbell to write a favorable article about ASI causing the price of the ASI stock to rise. ASI, as an inducement, sold Campbell 5,000 shares of ASI at a price below the market price. After the price of ASI stock rose, Campbell sold many of his recently acquired shares at a substantial profit. Campbell did not disclose his purchase of ASI stock to the investing public when he wrote the complimentary article on ASI. The Court of Appeals for the Ninth Circuit held that Campbell violated Section 10(b) and Rule 10b-5. The court acknowledged that Campbell's "relationship with the public was not a fiduciary one, under the common law," but stated that the absence of such a relationship is not dispositive of the Section 10(b) and Rule 10b-5 claim. Id. at 1269.
rity of our securities markets." Thus, Section 10(b) and Rule 10b-5 liability should attach to any person possessing material information unavailable to the investing public and should not be limited to a fiduciary or a person occupying a special relationship with the issuer or a tippee of such person. This interpretation makes critical the resolution of the question whether Section 10(b) and Rule 10b-5 cover market information.

**Market Information Falls Within the Ambit of Section 10(b) and Rule 10b-5**

The novel fact that Chiarella used market information, rather than corporate information, for his personal gain by purchasing securities without disclosing the impending tender offers should not shield him from Section 10(b) and Rule 10b-5 liability. Section 10(b) and Rule 10b-5 are addressed to the misuse of any material nonpublic information and contain no language limiting their application to corporate information, information dealing with the ability of the company's underlying assets to generate a stream of income, or information originating and emanating from the company whose securities are purchased or sold. Thus, the prohibitions of the section and the rule cover any information which could have a significant tendency to affect the decision of a reasonable investor in deciding to purchase or sell securities. In 1943, the Second Circuit Court of Appeals in *Charles Hughes & Co. v. SEC* declared that "the essential objective of securities legislation is to protect those who do not know market conditions from the overreaching of those who do." Likewise, in *Texas Gulf Sulphur* the court recognized that Section 10(b) and Rule 10b-5 are "based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information." The court did not read Section 10(b) and Rule 10b-5 as imposing any restrictions that the material nonpublic information had to either deal with the issuer corporation's earning power or originate and emanate from the company whose securities are purchased or sold.

In *SEC v. Capital Gains Research Bureau, Inc.* the defendant, a registered advisory investment service, published monthly reports recommending securities for long term investment. The defendant purchased stock for its account without disclosing the

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54. United States v. Chiarella, 588 F.2d at 1369.
55. Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1943).
56. SEC v. Texas Gulf Sulphur Co., 401 F.2d at 848.
purchases immediately before recommending the stock. Following the defendant's recommendation in the monthly report, the price of those securities rose. The defendant, after the rise in price triggered by its recommendations, sold the shares at a significant profit. The Supreme Court held that the defendant's purchase and sale of these securities, sandwiched around a recommendation, constituted a fraud in violation of the Investment Advisers Act. The Court recognized that these practices compromised the defendant's integrity, since the practice would tend to cause the defendant to recommend volatile securities which would be more susceptible to wide price fluctuations. This affected the disinterestedness of the defendant as an investment adviser. The Court held that investors "seeking the advice of a registered investment adviser must . . . be permitted to evaluate such overlapping motivations." However, the cases relied upon by the Court were not cases dealing with the antifraud provisions of the Investment Adviser Act. The Court cited Section 10(b) and Rule 10b-5 cases recognizing that material information not dealing with the earning power of the companies whose securities were purchased and sold and originating and emanating outside the corporation whose securities were purchased or sold may affect the demand for those securities and falls within the prohibitions of the antifraud provisions of the federal securities laws.

In Courtland v. Walston & Co., the defendant, publisher of a weekly mail letter on securities, had given notice of its recommendations to favored customers before publishing the recommendations. The court acknowledged that the price of a corporation's securities is "affected by the management, success and progress of the enterprise, and of the industry in which the issuer is engaged." However, the court emphasized that market information also influences the price of a corporation's securities.


59. 375 U.S. at 196.

60. Norris & Hirschberg v. SEC, 177 F.2d 228 (2d Cir. 1949); Charles Hughes & Co. v. SEC, 139 F.2d 494 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1943); Speed v. Transamerica, 99 F. Supp. 808 (D. Del. 1951).


62. Id. at 1084.
The price is affected "by current market trends, cost of money and the forces of supply and demand applied to the particular stock." The court noted that these "economic factors unrelated to the issuer or its industry, tend to make a respected market letter, in a sense, a self-fulfilling prophet."

*United States v. Peltz,* although not a Section 10(b) and Rule 10b-5 case, is analogous, and the court's reasoning should be applied in this area. The court held that one who possesses material nonpublic market information about a company which would affect the demand for the company's securities may not use that information to make purchases or sales of the company's securities while the information remains nonpublic. The court found Peltz guilty of conspiring to defraud the United States and the SEC by using nonpublic information on impending Commission action against Georgia Pacific, which he had obtained from an employee of the SEC, in making sales of Georgia Pacific stock. The court stated:

> It scarcely needs argument that the high repute and effective functioning of the SEC—conspicuous for its zeal in preventing the misuse of insider information . . .—would be significantly compromised by arrangements whereby an individual could obtain information about its impending action from one of its employees and profit from having such knowledge before this became available to the public generally. Public confidence essential to the effective functioning of government would be seriously impaired by any arrangement that would enable a few individuals to profit from advance knowledge of governmental action. The very making of a plan whereby a government employee will divulge material information which he knows he should not is "dishonest" within Chief Justice Taft's language in *Hammerschmidt*, regardless of whether such plan is secured by consideration.66

In a significant footnote the court observed that the decision's rationale was not limited to the Commission and its employees.67 The court noted that an arrangement with the secretary or law clerk of a federal judge to be provided information about decisions impacting on the demand for the securities of a company

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63. *Id.*
64. *Id.*
66. *Id.* at 52 (citations omitted).
67. In thus noting the peculiar irony of the use of inside information of impending SEC action, we do not mean at all to limit our holding to that agency. Similar considerations would apply in many other instances that readily come to mind. Arrangements to obtain advance information with respect to rate decisions of the ICC, FFC, FCC, and CAB, of merger decisions of the ICC, of the issuance of television licenses by the FCC or airline certificates by the CAB, or of the approval of foods or drugs by the FDA, are only a few examples. An arrangement with the secretary or law clerk of a federal judge to secure advance information with respect to a decision having implications for the stock market would be another.

*Id.* at 52 n.4.
would be prohibited.  

In *Blyth & Co.*, the Commission held that Blyth, a broker-dealer, violated Section 10(b) and Rule 10b-5 by using material nonpublic market information involving the terms of new government financing, which influenced the market price of currently issued government securities. Blyth had received the material nonpublic information from an employee of the Federal Reserve Bank of Philadelphia, who had been provided the information confidentially by the Treasury Department. Blyth misused the material nonpublic information by purchasing and selling currently issued government securities for its own account without disclosing the material nonpublic information. The Commission stressed that material nonpublic market information may not be used to obtain an unfair advantage in the purchase and sale of securities.

In *Affiliated Ute* the Supreme Court held that Section 10(b) and Rule 10b-5 reach the misuse of material nonpublic market information. *Affiliated Ute* involved 85 Indian plaintiffs who had been shareholders of the Ute Development Corporation. The corporation had been created by the Affiliated Ute Citizens, an unincorporated association whose members were of mixed blood, under the Ute Partition Act. The Act authorized partition and distribution of the Ute tribal assets between mixed blood and full blood Indians. The corporation named the First Security Bank of Utah as transfer agent for its stock certificates. Employees of the bank, who were acting as market makers in this stock, encouraged the Indian shareholders to sell their shares to the bank.

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68. The American Law Institute's proposed Federal Securities Code does not resolve the issue of trading on market information.

[I]t is hard to find justification today for imposing a fiduciary's duty of affirmative disclosure on an outsider who is not a "tippee." It would be convenient to have a new category of "quasi-insider" that would cover people like judges' clerks who trade on information in unpublished opinions, Federal Reserve Bank employees who trade with knowledge of an imminent change in the margin rate . . . and perhaps persons who are about to give profitable supply contracts to corporations with which they are not otherwise connected, while excluding persons who have merely decided to "go into the market in a big way." But all this does not lend itself to definition. It is difficult in the abstract to opine even on illustrative cases. Where, for example, would one place the outsider who is about to make a tender offer—or his depository bank?


and the bank's employees. They did not disclose to the Indian sellers that the price for which the shares were selling in the secondary market was significantly higher than the Indian sellers believed. The Court held that the purchases of the securities by the bank and the bank's employees from the Indians without disclosing the value of the corporation's shares in the secondary market violated Section 10(b) and Rule 10b-5. The Court emphasized that the "sellers had the right to know . . . their shares were selling for a higher price in [the secondary] market." 72

The facts of Securities Exchange Commission v. Shapiro 73 are analogous to the Chiarella case. In Shapiro the defendants were consultants employed by Ridge Manor Development Corporation in its attempt to acquire Harvey's Stores, Inc. by merger. The defendants, without disclosing the proposed merger, purchased shares of Harvey's for their personal gain. The defendants sold their shares at a significant profit after Ridge Manor's merger plan was announced. The Second Circuit Court of Appeals held that the defendants' misuse of material nonpublic market information fell within the purview of Section 10(b) and Rule 10b-5.

The gain to be obtained from purchasing or selling securities and the inherent unfairness to public investors are as great from the misuse of market information as from corporate information. Market information dealing with tender offers or other types of acquisitions is of immense significance to investors. The price of a corporation's securities is affected by the demand for those securities. Demand for securities increases during tender offers or other acquisition efforts when the offeror offers to pay a premium above the existing market price for the securities. Knowledge of an impending tender offer, in which such a premium is being offered, is knowledge that the shares of the target company in the near future will be worth far more than the seller has reason to know on the available information. Purchasing securities on the basis of such information which is unavailable to the investing public is an act of deception forbidden by Section 10(b) and Rule 10b-5.

The Supreme Court, in an important footnote in Superintendent of Insurance v. Bankers Life & Casualty Co., said that Section

72. 406 U.S. at 153. The Supreme Court had earlier recognized the importance of market information in Silver v. New York Stock Exch., 373 U.S. 341, 348 (1963):

Without the instantaneously available market information provided by private wire connections, an over-the-counter dealer is hampered substantially in his crucial endeavor—to buy, whether it be for customers or on his own account, at the lowest quoted price and [to] sell at the highest quoted price.

73. 494 F.2d 1301 (2d Cir. 1974).

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10(b) and Rule 10b-5 "prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden-type variety of fraud, or present a unique form of deception." The Court noted that "novel or atypical methods should not provide immunity from the securities laws." Congress, in using the language "any manipulative or deceptive device" did not intend to limit Section 10(b) only to the misuse of corporate material information or information originating and emanating from the company whose securities were purchased or sold. Section 10(b) was designed "as a 'catch-all' clause to enable the Commission to deal with new manipulative [or cunning] devices" and Rule 10b-5 was promulgated pursuant to Section 10(b) to cover the misuse of any information, including market information, which could reasonably be calculated to have an effect on a person's decision to purchase or sell securities.

EXCEPTION FOR TENDER OFFERORS

One major area of market information is a person's knowledge of his intent to embark on a tender offer campaign. Former Commission Chairman Cohen stated:

There is . . . one area, now largely neglected, where an outsider may well be the only possible source of material information: where he is embarking on a purchase program with the intent or the potential of obtaining control, changing management, adopting new policies, moving in new directions. . . . [In this instance] the outsider is actually an insider, and his inside information may be of great importance to investors.

However, no court has held that a person violates Section 10(b) and Rule 10b-5 by purchasing shares of the company to be acquired in their tender offer. In General Time Corp. v. Talley Industries, Inc., a decision rendered two months after the Texas Gulf Sulphur decision, Talley purchased shares of General Time in the open market without disclosing to the sellers the merger plan, "whose terms might be more favorable than the price paid for the stock being acquired." The Second Circuit Court of Appeals held Talley's purchase of General Time stock without disclosing Talley's impending tender offer for the company did not

75. Id.
violate Section 10(b) and Rule 10b-5. The court refused to hold that Talley had an "obligation to reveal circumstances that might raise a seller's demands and thus abort the sale." 79

The Second Circuit in Chiarella stated that "the offerors and Chiarella occupy entirely different positions with respect to trading on news of an impending tender offer." 80 The court thought that prospective tender offerors, in making purchases of target company shares, exposed themselves to "substantial economic risk" 81 in contrast to Chiarella, who took "no economic risk whatsoever." 82 The district court, in denying Chiarella's motion to dismiss the complaint for failure to state an offense, distinguished prospective tender offerors' purchases of target stock from Chiarella's purchases. The court stated that purchases by tender offerors "have a presumptively legitimate business purpose to promote economic growth and are appropriately made without disclosure" 83 compared to Chiarella whose purchase, based on the same material information, "was solely for personal profit, serving no business purpose." 84 The court of appeals did not rely "on any concept of 'business purpose' in distinguishing Chiarella from offerors. . . ." 85 The court, citing Santa Fe Industries, Inc. v. Green, 86 stated that "'business purpose' cannot be dispositive of liability under [Section 10(b) and] Rule 10b-5." 87

Purchases of target securities by persons about to make tender offers while withholding that material nonpublic information from sellers, and purchases of target securities by persons possessing knowledge of the impending tender offers without disclosing their knowledge are superficially analogous. The shares of the target companies are sold by a company shareholder who, unlike the purchaser, does not know that the shares are about to be sought after in a tender offer. However, Section 10(b) and Rule 10b-5 are especially aimed at "manipulative and deceptive practices which have been demonstrated to fulfill no useful function." 88 The use of material nonpublic information possessed by a prospective tender offeror is significantly different from the use of such infor-

79. Id.
81. Id. at 1366-67.
82. Id. at 1367.
84. Id.
85. 588 F.2d at 1368 n.15.
87. 588 F.2d at 1368.
88. Id. at 1368-69.
mation by a person who merely has knowledge of the impending tender offer.

The Talley case involved corporate information used by the corporation for its own purposes and the court upheld the right of a purchaser to withhold its intentions from sellers of stock. However, the right of withholding material knowledge of impending tender offers should not extend to anyone engaging in purchases or sales of securities besides the prospective tender offeror.

The provisions of Section 10(b) and Rule 10b-5 should apply to purchases of the target company's stock by lawyers, accountants, investment bankers, or any others who, like Chiarella, assist tender offerors. Such transactions might well trigger a rise in the price of the target company's stock and could, thereby, abort the tender offer.

More importantly, a distinction under Section 10(b) and Rule 10b-5 between the prospective tender offeror and the person merely possessing knowledge of an impending tender offer is in accordance with the expectations of investors. Investors realize that Section 10(b) and Rule 10b-5 do not reach certain characteristics among investors such as intelligence, diligence, research and wealth. In Texas Gulf Sulphur the court stated that "[i]t was the intent of Congress that all members of the investing public should be subject to identical market risks."\textsuperscript{89} The court recognized that market risks include "the risk that one's evaluative capacity or one's capital available to put at risk may exceed another's capacity or capital."\textsuperscript{90} The court stressed that Section 10(b) and Rule 10b-5 do not compel anyone to provide other "investors the benefit of his superior financial or other expert analysis by disclosing his educated guesses or predictions."\textsuperscript{91} The Commission in Cady, Roberts emphasized that "knowledge of this action [a cut in dividends] was not arrived at as a result of perceptive analysis of generally known facts . . . ."\textsuperscript{92}

\textsuperscript{90} Id.
\textsuperscript{91} Id. at 848.
\textsuperscript{92} Cady, Roberts & Co., 40 S.E.C. at 915.
observation or analysis."\(^{93}\)

Tender offerors use their analytical ability to evaluate generally known facts when making the decision that certain companies' securities are undervalued by the market. However, persons like Chiarella, who are confidentially provided material nonpublic information of the impending tender offer, do not acquire the information through "general observation or analysis" and have an unfair advantage in making purchases of the target company's securities as a result of unequal access to material information.

**SECTION 10(b) AND RULE 10b-5 REQUIRE EQUAL ACCESS TO MATERIAL INFORMATION AMONG PURCHASERS AND SELLERS OF SECURITIES**

The Second Circuit Court of Appeals in *Chiarella* came close to announcing an equal access to material information standard in stating that "'all investors trading on impersonal exchanges [should] have relatively equal access to material information.'\(^{94}\) The requirement of equal access to material information among purchasers and sellers of securities, although not the stated ground for any Section 10(b) or Rule 10b-5 decision, is a principle which has been recognized in Section 10(b) and Rule 10b-5 litigation.

In *Texas Gulf Sulphur* the court announced that a primary purpose of Section 10(b) and Rule 10b-5 is to insure the investing public equal access to material information and thereby equal access to the rewards of participating in the securities market. The court stated that the section and rule are based "in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."\(^{95}\) The court noted that "[t]he core of Rule 10b-5 is the implementation of the congressional purpose that all investors should have equal access to the rewards of participation in securities transactions."\(^{96}\) The court emphasized that "all members of the investing public should be subject to identical market risks [and] inequities based upon unequal access to knowledge should not be shrugged off as inevitable . . . or, in view of the congressional concern in the area, remain uncorrected."\(^{97}\)

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93. Investors Management Co., 44 S.E.C. at 641 n.18.
95. SEC v. Texas Gulf Sulphur Co., 401 F.2d at 848.
96. Id. at 851-52.
97. Id. at 852.
The Texas Gulf Sulphur view that the objective of Section 10(b) and Rule 10b-5 is to insure the investing public equal access to material information was recognized earlier. In Speed v. Transamerica Corp., Transamerica, the controlling stockholder of Axton, Fischer Tobacco Company (Axton), made an offer to purchase and caused the call of the remaining Class A stock owned by the other shareholders for redemption. The shareholders had received a financial statement from Axton for 1941. Transamerica, in making the offer to purchase the other shareholders' shares, did not disclose that the market value of Axton's tobacco inventory greatly exceeded the cost value shown in Axton's financial statement and that Axton's earnings had improved after the 1941 financial statement. Furthermore, Transamerica failed to disclose its intentions to liquidate Axton with the assets being distributed to Class B stock, of which Transamerica owned a major portion, in an effort to take advantage of Axton's tobacco inventory market value.

The Second Circuit Court of Appeals determined that Transamerica, in making the purchase offer and stock call, planned to capture the inventory profit through liquidation or merger. The court held that Transamerica violated Section 10(b) and Rule 10b-5 by failing to disclose to the sellers material nonpublic information needed to make a rational investment decision. The court declared that the equalization of bargaining power among purchasers and sellers of securities was a primary goal of Section 10(b) and Rule 10b-5.

The Second Circuit Court of Appeals came close to enunciating a parity of information principle, a more stringent standard than

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Unfair profits can on occasion be made in share dealings by the improper use of confidential, price-sensitive information that is not generally available to the investing public. This is prima facie most likely to happen in a bid, or expected bid, situation, but in principle it can happen at any time. The efficient operation of the market as a source of capital, as a measure of industrial success and hence as a means of achieving a desirable and efficient disposition of resources, requires that relevant information should be fairly available, and that all investors should be able to back their knowledge and judgment rather than that favored individuals should be able to take private advantage of confidential information. These requirements have so far been fulfilled by the application of the rules of the Stock Exchange and, in bid situations, by the Take-Over
an equal access requirement, in *SEC v. Great American Industries, Inc.* The Commission brought an injunctive proceeding when persons conveyed property to Great American Industries in return for shares in the corporation. The Commission claimed that the purchasers of the securities had violated Section 10(b) and Rule 10b-5 by not disclosing to the sellers of the securities, Great American Industries, the material fact that a significant portion of the securities they received would go to finders. The majority of the court, sitting en banc, granted injunctive relief because Great American Industries had issued misleading press releases and filed misleading reports with the Commission. Since the case was not limited to nondisclosure, the court did not decide whether purchasers of securities have a duty of disclosure to the sellers. However, the court recognized that imposing on purchasers of securities "a duty of full disclosure . . . would increase the protection afforded investors and traders by the securities laws." The court did not rest its decision on that ground since a holding that Section 10(b) and Rule 10b-5 place "an affirmative duty of disclosure on persons who, in contrast to 'insiders' or broker-dealers [do] not occupy a special relationship to a seller . . . of securities, would be occupying new ground and would require most careful consideration." Three judges, including Judge Kaufman, indicated a willingness to impose upon purchasers of securities a duty of disclosing material nonpublic information to the sellers. Judge Kaufman stated that "any claim that material facts were withheld in a transaction in connection with the sale or purchase of securities must be scrutinized with care, whether or not there would have been liability at common law for such a deed." Courts other than the Second Circuit have rendered decisions reflecting an equal access to material information standard. In Panel. Without implying that malpractice has been widespread, the Government has concluded that it is necessary for the voluntary system to be reinforced by statute so as to ensure, as far as practically possible, that the market operates freely on the basis of equality between buyer and seller. Care must be of course taken to avoid unduly inhibiting the flexibility of the market. But the general desirability of ensuring equality of information to all potential or actual investors, and hence a proper disposition of the resources available to those investors, must have a high priority. The successful operation of the system demands a high degree of confidence in fair dealing on the Stock Exchange, and indeed in securities generally, whether or not publicly quoted.

Id. at 8.
101. Id. at 460.
102. Id.
103. Id. at 463.
Birdman v. Electro-Catheter Corp.,\textsuperscript{104} persons who owned restricted securities did not disclose to the investing public the probable future market impact of their contemplated sale of 15,000 shares of these securities, without registration, in a market of 60,000 shares. The court said: "The omission of such information, if material, would thwart the basic policy of Rule 10b-5 . . . which is that all investors have relatively equal access to material information."\textsuperscript{105}

In Courtland v. Walston & Co.,\textsuperscript{106} discussing the plaintiff’s failure to disclose the material nonpublic information received from defendants in making purchases of securities, the court came close to accepting an equal access to material information test. The plaintiff was one of the favored customers who purchased securities on the basis of the advance notice that the securities would be recommended in the defendant’s securities letter. The court indicated that the publishers, by providing their recommendations in advance to selected customers, caused substantial unfairness and unjust preferences constituting a fraud in violation of Section 10(b) and Rule 10b-5 on sellers of these securities. The court declared that the plaintiff

knew, or must be deemed to have known, that if she received recommendations prior to the publication of the market letter, and bought the stock recommended, she would be taking advantage of sellers who would be selling the stocks without benefit of such special knowledge and who, if the market letter pushed up the stock, would be financial losers to that extent.\textsuperscript{107}

The Commission adopted a similar position in Merrill, Lynch, Pierce, Fenner & Smith, Inc.\textsuperscript{108} The Commission indicated that Merrill Lynch would have violated Section 10(b) and Rule 10b-5 even if they had informed all of their customers of Douglas’ decline in earnings instead of selectively disclosing the material information to institutional clients. The Commission stated that the selective disclosure to favorite groups "who could utilize it for their own benefit, and to the detriment of public investors to whom the information was not known, constituted an act, practice, or course of business which operated or would operate as a

\textsuperscript{105} Id. at 1274.
\textsuperscript{107} Id. at 1084.
\textsuperscript{108} 43 S.E.C. 933 (1968).
fraud or deceit upon such investors."\textsuperscript{109}

The Commission likewise stressed the need for equal access to material information among purchasers and sellers of securities in \textit{Faberge, Inc.}\textsuperscript{110} The Commission did not focus on the corporate nature of the information but emphasized that the information was material and nonpublic. The Commission declared that "the objective of a fair market cannot be achieved when one of the parties to the transaction has inside information unavailable to the other."\textsuperscript{111} The Commission warned that "few practices short of manipulation have as deleterious an effect on the investing public's confidence . . . in the securities markets as the selective disclosure of and misuse of so called inside information, \textit{i.e.}, material nonpublic information."\textsuperscript{112}

The Commission's complaint in \textit{SEC v. Campbell}\textsuperscript{113} reaffirms the abandonment of a special relationship that creates an independent duty to disclose. The Commission in 1972 brought an injunctive proceeding against Alex N. Campbell, a widely read financial reporter for the \textit{Los Angeles Herald Examiner}. The Commission claimed that at least seventy-eight times Campbell purchased securities of a company before the \textit{Los Angeles Herald Examiner} published an article written by Campbell which was highly complimentary of the company. The Commission claimed that in approximately 75\% of these instances the price of these companies' securities had risen 10\% to 100\% after the publication of Campbell's article. The Commission alleged that Campbell violated Section 10(b) and Rule 10b-5 by not disclosing to the sellers of these securities that he had an article awaiting publication which would present the issuers favorably to the investing public. Campbell entered into a consent decree with the Commission in which he agreed to entry of a permanent injunction against these practices. The SEC's complaint underscores the view that Section 10(b) and Rule 10b-5 require equal access to material information. Although Campbell had a special relationship with his readers he did not have a special relationship as a purchaser or seller of securities with other investors.

The court's adoption in \textit{Chiarella} of an equal access to material information standard would further the goals of Congress in enacting the 1934 Act and would be sound public policy. A person purchasing or selling securities on the basis of material informa-

\begin{footnotes}
\item[109.] \textit{Id.} at 937 (emphasis added).
\item[111.] \textit{Id.}
\item[112.] \textit{Id.}
\item[113.] Civ. No. 72-1684-WMD (C.D. Cal. 1972).
\end{footnotes}
tion unavailable to the investing public violates Section 10(b) and Rule 10b-5 because the transactions constitute an "act, practice, or course of business which . . . would operate as a . . . deceit upon any person." The Supreme Court in *Affiliated Ute* acknowledged that "the 1934 Act and its companion legislative enactments embrace a 'fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of caveat emptor.'"114 Congress reaffirmed these goals in 1975 when, in amending the Securities and Exchange Act of 1934, it stated: "The basic goals of the Exchange Act remain salutory and unchallenged: to provide fair and honest mechanisms for the pricing of securities, [and] to assure that dealing in securities is fair and without undue preferences or advantages among investors. . . ."115

An equal access to material information standard would help to assure that the price of a security would have a high correlation to its actual value. Congress has recognized the importance of investor access to material information in the adequate pricing of securities:

> The concept of a free and open market for securities necessarily implies that the buyer and seller are acting in the exercise of enlightened judgment as to what constitutes a fair price. Insofar as the judgment of either is warped by false, inaccurate, or incomplete information regarding the corporation, the market price fails to reflect the normal operation of the law of supply and demand.116

An equal access standard would also increase the allocative efficiency of the capital market since, with equal access to material

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> If investor confidence is to come back to the benefit of exchanges and corporations alike, the law must advance. . . . Unless constant extension of the legal conception of a fiduciary relationship—a guarantee of 'straight shooting'—supports the constant extension of mutual confidence . . . easy liquidity of the resources in which wealth is invested is a danger. . . . Just in proportion as it becomes more liquid and complicated, an economic system must become more moderate, more honest, and more justifiably self-trusting.

H.R. REP. No. 1383, 73d Cong., 2d Sess. 5 (1934).

It is my hope and expectation that a wise and judicious administration of the provisions of this act will create a new confidence in the integrity of the security markets. . . . "If there were a justifiable belief that security markets actually were 'free and open', that all buyers and sellers met on substantially equal terms, . . . the response would be a greater investment interest in securities and a consequent improvement in all phases of the security business."


information, investors will be able to make better investment de-
cisions, thereby allocating resources more efficiently.

AN EXCEPTION FOR PURCHASERS AND SELLERS OF SECURITIES
FULFILLING ESSENTIAL MARKET TASKS

Equal access to material information among purchasers and
sellers of securities should be required except in those rare occa-
sions when the person purchasing or selling securities based on
nonpublic material information is performing a vital market func-
tion. The court of appeals in Chiarella noted it should not "be un-
derstood as holding that no one may trade on nonpublic market
information without incurring a duty to disclose." 117 Likewise, in
Affiliated Ute the Supreme Court did not hold that there had to
be equal access to material information among all purchasers or
sellers of securities. The Court acknowledged that if the bank
and its employees "had functioned merely as a transfer agent,
there would have been no duty of disclosure." 118

An exception to the equal access information standards should
be made for specialists. Specialists are members of national stock
exchanges given the responsibility of maintaining a fair and or-
derly market in assigned stock or stocks. The exchanges require
specialists, within reasonable limits, when there is a purchaser
but not a seller, or seller but not a purchaser in their assigned
stocks, to make from their own account purchases and sales of
the stocks, to minimize price differences resulting from temporary
imbalance in the supply and demand of the securities and to add
depth and liquidity to the market of the securities.

Specialists often purchase and sell securities while possessing
nonpublic material market information. Specialists maintain
books which contain information concerning limited price orders
received from other traders to purchase or sell securities at a des-
ignated price that does not match the current market price. Spe-
cialists execute the purchase or sale if the market price moves to
the desired price. This information possessed by the specialist
has an importance beyond that of a mere repository of unex-
cuted agency orders. The information serves as a barometer of
public interest in a particular security.

Congress has taken precautions to prevent the specialist from
abusing this access to material nonpublic information. The spe-
cialist is forbidden "to reveal the orders on his books to favored
persons. This information must be available to all members or

117. United States v. Chiarella, 588 F.2d at 1366.
else kept entirely confidential. The specialist is likewise prohibited from exercising purely discretionary orders as distinct from market or limited price orders.\textsuperscript{119} Congress has designed Section 11(b)\textsuperscript{120} of the 1934 Act to eliminate the dealer activities of a specialist except insofar as such activities constitute a vital service to the market. Section 11(b) allows specialists to purchase or sell securities for personal gain on the basis of material nonpublic information only if the transactions enable the specialists to help create a fair and orderly market in their assigned securities. The "quid pro quo" for permitting the specialist to trade on material nonpublic market information "has been the imposition of regulation to assure that in trading for his own account he uses those privileges for the benefit of the market generally."\textsuperscript{121}

The congressional policy has been to regulate the specialists "rather than to eliminate their informational advantage deriving from their function in the market place and thereby to deny to the public their contribution to the functioning of the market mecha-

\textsuperscript{119} S. REP. No. 792, 73d Cong., 2d Sess. 18 (1934); H.R. REP. No. 1363, 73d Cong., 2d Sess. 25, 30 (1934).

\textsuperscript{120} It shall be unlawful for a specialist or an official of the exchange to disclose information in regard to orders placed with such specialist which is not available to all members of the exchange, to any person other than an official of the exchange, a representative of the Commission, or a specialist who may be acting for such specialist. It shall also be unlawful for a specialist permitted to act as a broker and dealer to effect on the exchange as broker any transaction except upon a market or limited price order. 15 U.S.C. § 78k(b) (1976).

In adopting Section 11(b), Congress expressed concern about the unfairness involved in allowing traders to take advantage of informational inequities for personal gain:

Is there not a danger that a few men on the inside, the officers of the Exchange, may secure from the specialist in advance any and all information they desire, precisely as they have heretofore?

Will they not still be able to obtain information that will apprise them in advance of all the other members of the exchange knowledge of the accumulated overnight orders to buy or sell various stocks, the amount and the prices at which the sellers will sell, and the prices at which buyers are willing to buy? ... Armed with this confidential information, they would be able easily to decide what course to pursue as between buying or selling. Or, in other words, ... they would have the opportunity of looking into all the other players' hands and then of making their bets at this gambling table in safety not only to the disadvantage of outside investors but even to the disadvantage of their fellow members of the gambling fraternity as well. It is practically the same as if they were playing with marked cards.

nism.” Thus, specialists who comply with Section 11(b) should be exempt from the equal access standard and not be subject to the prohibitions of Section 10(b) and Rule 10b-5 for trading on material nonpublic information.

CONCLUSION

Chiarella should be held to have violated Section 10(b) and Rule 10b-5 by purchasing securities on the basis of material nonpublic information unavailable to the investing public. Indeed the investing public had no legitimate means of obtaining the information about the impending tender offers. The requirement to disclose material nonpublic information should not depend upon a duty arising out of other relationships between purchasers and sellers of securities. Section 10(b) and Rule 10b-5 are directed at the elimination of fraud in connection with the purchase or sale of securities and the existence of some parallel or independent duty between purchasers and sellers of securities should not be a precondition for their applicability. An equal access to material information standard for Section 10(b) and Rule 10b-5 would not penalize investors who do not disclose information which they have acquired through legitimate research or other basic economic efforts if the information is available to the investing public and no other relationship requiring disclosure exists between the traders.