NEWS

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 272-2650

Remarks To

ALI-ABA

SECURITIES LITIGATION PROGRAM

BOSTON, MASSACHUSETTS

June 2, 1983

INSIDER TRADING AND THE DUTY ANALYSIS AFTER CHIARELLA

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The views expressed herein are those of Commissioner Treadway and do not necessarily represent those of the Commission, other Commissioners, or the staff.

INSIDER TRADING AND THE DUTY ANALYSIS AFTER CHIARELLA

I. INTRODUCTION

Since the Supreme Court's decision in Chiarella v. U.S., 445 U.S. 222(1980), many have contended that the law of insider trading has been in a state of some confusion, particularly as applied to the area of parties who trade on the basis of non-pubic information but who do not have the traditional, direct relationship with the issuer which clearly gives them the status of an "insider." Most or all of that confusion arises from the Chiarella holding that no violation of Rule 10b-5 occurs when a person trades on the basis of non-public, material "market information," unless the alleged violator has "a duty to disclose arising from a relationship of trust and confidence between parties to a transaction."

Before reviewing some recent cases dealing with "non-traditional insiders" in light of the duty analysis of Chiarella, let us again briefly review Chiarella. Chiarella was a "mark-up man" in the composing room of a financial printer. Bidding materials sent to the printer omitted or disguised the names of the bidders and targets, with correct names provided at the time of the final printing. Chiarella deduced the names of the targets before the final printing, purchased stock in the targets before, and sold the stock immediately following, the takeover announcements. He subsequently was convicted of violating Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. The Court of Appeals for the Second Circuit affirmed.

In a 6-3 decision, with five separate opinions, the Supreme Court reversed. Justice Powell, writing for the majority, stated:

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

In so holding, the Court expressly rejected a "parity-of-information" theory, which was the foundation of the lower courts' opinions.

The Court further stated:

> "[S]ilence in connection with the purchase or sale of securities may operate as a fraud actionable under §10(b). ... <u>But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction</u>. ... No duty could arise from petitioner's relationship with the

sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions." (Emphasis added.)

In dissent, Chief Justice Burger argued that Chiarella's conviction could be sustained on the theory that he had misappropriated information from his employer, but the Court declined to decide this question because that theory had not been submitted to the jury.

In a concurring opinion, Justice Stevens argued that, if it had been properly presented to the jury, perhaps "the petitioner's breach of his duty of silence - a duty he unquestionably owed to his employer and his employer's customers - could give rise to criminal liability under Rule 10b-5." He said that "[r]espectable arguments could be made in support of either position."

In a dissent in which Justice Marshall concurred, Justice Blackmun wrote:

" I would hold that persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging

> in schemes to exploit their structural informational advantage through trading in affected securities."

This position is premised upon the theory that the "special facts" doctrine has extended the common law concepts of fraud and fiduciary relations. Justice Blackmun further stated:

> "The common law of actionable misrepresentation long has treated the possession of 'special facts' as a key ingredient in the duty to disclose. Traditionally, this factor has been prominent in cases involving confidential or fiduciary relations, where one party's inferiority of knowledge and dependence upon fair treatment is a matter of legal definition, as well as in cases where one party is on notice that the other is 'acting under a mistaken belief with respect to a material fact.' ... Steps have been taken toward application of the 'special facts' doctrine in a broader array of contexts where one party's superior knowledge of essential facts renders a transaction without disclosure inherently unfair."

Chief Justice Burger agreed with the general rule that neither party to a arm's length business transaction has a duty to disclose information to the other, unless the parties stand in some confidential or fiduciary relation. He argued, however, that:

> "[T]he policies that underly the rule also should limit its scope. In particular, the rule should give way when

an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means.... I would read §10(b) and Rule 10b-5 ... to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading." (Emphasis added.)

Although Justice Brennen agreed with the Chief Justice's analysis, he concurred in the majority's decision because he belived that the legal theory discussed by Chief Justice Burger had not been presented to the jury.

Taking all of those views into account, Chiarella leaves us with four possible theories under which someone other than a traditional insider can violate Rule 10b-5 by trading on non-public information:

1. The violation can be based upon a "special relationship" between the parties, giving rise to a duty to disclose.

2. The violation can occur because one person had access to confidential material information not legally available to others and thereby became subject to a duty to disclose.

3. The violation can occur because a person misappropriated information and thereby became subject to an absolute duty of disclosure.

4. The violation can occur because a person who misappropriated information committed a fraud or deceit "in connection with the purchase or sale of any security."

Given that theoretical range, diversity of opinion and inventive approaches to the duty concept were inevitable.

II. SOME POST-CHIARELLA CASES

A. Tippees: How Does the Duty Arise?

Tippees, of course, are the most common examples of those who, directly or indirectly from a recognized corporate insider, have obtained material, non-public information about an issuer. Possibly the most celebrated tippee case is Dirks v. SEC, 681 F.2d 824 (D.C. Cir. 1982), a case currently before the Supreme Court. Dirks was a financial analyst, specializing in insurance companies. Through current and former employees of Equity Funding, Dirks learned of a massive fraud at Equity Funding. Dirks then tipped institutional investors, who sold $18 million of stock in the market before the information became public. In an administrative proceeding, the Commission found that, by tipping others who then traded, Dirks willfully aided and abetted violations by the trader of Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act and Rule 10b-5. The Court of Appeals for the District of Columbia affirmed.

Because Dirks had obtained his information from corporate employees, the Court of Appeals held that Dirks "stands in the shoes" of his informants (who were insiders) and that he and his tippees inherited the insiders' duty to disclose or refrain from trading. In commenting on now famous footnote 12 in the Chiarella opinion, the Court of Appeals said:

> "A footnote in Chiarella commented that the Shapiro v. Merrill Lynch doctrine 'has been viewed as arising from [the tippee's] role as a participant after the fact in the insider's breach of fiduciary duty.' We do not think that Supreme Court meant this footnote to imply that the Shapiro v. Merrill Lynch doctrine requires breach of fiduciary duty even if breach is not required to make the insiders themselves liable. Nor do we think that it means that breach by insiders is necessary to make their 'tippees' answerable for acts that would have constituted a breach had they been committed by the insiders."

In addition to other theories of liability, and although the issue was not briefed or argued by the parties, the Court of Appeals said that a registered broker-dealer and its associated persons are under an independent duty to the SEC and the public.

> "[E]ven more important, Dirks himself had obligations to the SEC and the public completely independent of any

obligations acquired under the Shapiro v. Merrill Lynch doctrine. Those obligations, implicit in the scheme of broker-dealer registration under the federal securities laws, provide a basis for imposing a duty to disclose-or-refrain on Dirks even if we would not impose it on his sources at Equity Funding .... Dirks violated his duties to the SEC and the public by failing to report promptly what he knew. When his clients sold their Equity Funding stock without first disclosing the information Dirks had given them, they became 'participant[s] after the fact' in Dirks' breach of duty and they violated Rule 10b-5."

As can readily be seen, the difficulty in squaring tippee liability with the literal duty analysis of Chiarella arises from the fact that the tippee seldom has a pre-existing relationship with the issuer that, at least at first glance, seems sufficient to create a disclose-or-abstain duty. But the lower courts have generally endorsed the concept that, if the tippee knows he is acquiring confidential information from a corporate insider, he inherits the corporate insider's duty to disclose-or-abstain. The viability and reach of that theory is, of course, at issue in Dirks, which should be decided soon by the Supreme Court.

B. Duty Arising From Misappropriation

The principal case finding a duty based on misappropriation of non-public information by a non-traditional insider is U.S. v. Newman, 664 F.2d 12 (2d Cir. 1981). Newman, a securities trader at a brokerage firm, obtained confidential information about proposed mergers and acquisitions from two employees of two investment banking firms. In turn he conveyed the information to two foreigners. Using secret foreign bank accounts and spreading their purchases among brokers, the three conspirators purchased stock in the target companies. Profits were shared with the employees of the investment banking firms.

The District Court dismissed an indictment charging Newman under Section 10(b). The Court of Appeals for the Second Circuit reversed, citing the dissenting opinion of Chief Justice Burger in Chiarella:

> "By sullying the reputation of [the investment banking firms] as safe reposistories of client confidences, [Newman] and his cohorts defrauded those employers as surely as if they took their money."

The court was untroubled by the fact that the persons "defrauded" -- the employer investment banking firms -- were neither purchasers nor sellers of securities.

"... [S]ince appellee's sole purpose in participating in the misappropriation of confidential takeover information was to purchase shares of the target companies, we find little merit in his disavowal of a connection between the fraud and the purchase."

On April 8, 1983, Newman filed a petition for a writ of certiorari with the Supreme Court.

C. The Separate Duty Theory

O'Connor & Associates v. Dean Witter Reynolds, Inc., [current] Fed. Sec. L. Rep. (CCH) ¶99,143 (S.D. N.Y. 1983), is another case which seems to read the Chiarella duty analysis in a liberal fashion. O'Connor alleged that certain customers of Dean Witter and A.G. Becker had been tipped by insiders at either Standard Oil of California or Amax, Inc. concerning SoCal's intention to make a takeover bid for Amax and that those tippee-customers purchased Amax call options. O'Connor sold call options on Amax stock during the period of the purchases.

In considering the duty of the purchasers of the call options owed to O'Connor under the Chiarella duty analysis, the court first noted that corporate insiders owe a fiduciary duty to the corporation and its shareholders. But the court found the relationship between corporate insiders and shareholders to be in stark constrast to the lack of any relationship between corporate insiders and traders in options on the corporation's securities.

> "[w]hatever relationship this may create with the corporation, it cannot be said that it rises to the level of a relationship of trust and confidence between the options trader and the corporate insider. In short, as a shareholder one is entitled to the benefits of a trust relationship. As a options trader, one is not."

But that was not the end. Applying Newman, the court concluded that "because their trading or tipping breached fiduciary duties owed to other parties, the alleged conduct constituted a fraudulent practice within the meaning of the securities laws." The court held that options are a "security" within the meaning of Rule 10b-5 and that the tippees' purchase of these options constituted a purchase or sale of a security in connection with the fraudulent activity.

The court went further and posited an alternate theory of liability. Citing SEC v. Texas Gulf Sulfur, 401 F.2d 833 (2d Cir. 1968), Shapiro v. Merrill Lynch, 495 F.2d 228 (2d Cir. 1974), and Chiarella, the court stated:

> "....[B]y virtue of their fiduciary duty to the corporation and its shareholders, corporate insiders become subject to a separate duty to either 'abstain

or disclose.' Unlike the fiduciary duty, which is owed only to the corporation and its shareholders, this additional duty to disclose is owed 'to the investing public.' ... Thus, by virtue of the corporate insiders' duty to the corporation, they, and their tippees, indirectly come under a duty to O'Connor to 'abstain or disclose' if they possess material nonpublic information." (Emphasis added.)

Thus, although O'Connor was neither a purchaser nor seller of the securities of the corporation, he was nevertheless a beneficiary of the duty of the corporate insiders, and hence their tippees, to disclose nonpublic information.

The Court of Appeals for the Eighth Circuit has taken a contrary position. Laventhall v. General Dynamics Corporation, [current] Fed. Sec. L. Rep. (CCH) ¶99,154 (8th Cir. 1983), involved the purchase of call options on General Dynamics common stock. Without disclosing the pending declaration of a cash dividend, General Dynamics purchased shares of its common stock in the open market. Laventhall sold his call options on the morning of January 4. That afternoon, General Dynamics announced a cash dividend and a stock split. The Eighth Circuit first held that option holders are not shareholders of the corporation and therefore enjoy no relationship of trust and confidence imposing upon General Dynamics a special duty to the plantiff. The court rejected the notion in O'Connor that corporate insiders are subject to a "separate duty" to the O'Connor investing public. The court held that, notwithstanding the "separate duty" reasoning, there was no transactional connection between the plantiff's trading in options and the corporation's trading in common stock. The court believed that the options holder must at least deal in the same market as the insider for liability for nondisclosure to arise under Rule 10b-5.

Another Southern District of New York case also has limited the O'Connor "separate duty" theory. Moss v. Morgan Stanley, Inc., 553 F. Supp. 1347 (S.D. N.Y. 1983), arose from the Newman facts. Having sold stock of one of the targets prior to a takeover announcement, Moss sued Morgan Stanley (asserting vicarious liability), Newman, and two employees of Morgan Stanley, who were Newman's co-conspirators. In granting motions to dismiss, the court held that none of the defendants owed Moss a duty to disclose or abstain. The court aknowledged that a criminal violation of Section 10(b) can be based upon the breach of a duty owed to a party other than the party to a transaction, citing Newman. But the court stated:

> "Even though there may have been a fiduciary duty to Morgan Stanley and [the bidder] in this case, there is no support for the argument that this duty transformed itself into a duty owed to the stockholders of [the target], as is necessary for the finding that Moss has a

> claim for damages under Section 10(b).... The duty to disclose arises from a relationship between the parties. Here, the defendants were not insiders of [the target], had no fiduciary relation with [the target's] shareholders, and thus owed them no duty of disclosure. ... There is no 'duty in the air' to which any plaintiff can attach his claim." (Emphasis added.)

The court distinguished O'Connor, because the information in O'Connor came from insiders and O'Connor based much of its analysis on the duty of insiders. The court held that any other reading of O'Connor would flatly contradict the Chiarella requirement that a duty arise from a relationship between the parties. Thus, the court sought to narrow the "separate duty" theory of O'Connor, as well as the theory that a fraud on a third party in connection with the purchase and sale of a security can give rise to liability under Rule 10b-5.

D. Duty Arising From A Relationship of Friendship and Confidence

SEC v. Lund, [1981-82] Fed. Sec. L. Rep. (CCH) ¶98,428 (C.D. Cal. 1982), suggests that a relationship of trust and confidence can be implied between parties with a long-standing personal relationship. The defendant Lund, in his capacity as a corporate officer of Verit Industries, was approached by Horowitz, an officer of P&F, concerning a business venture. Lund then purchased P&F securities. In ruling upon cross-motions for summary judgment, the court identified three viable theories of liability under Section 10(b).

1. Lund was a tippee of Horowitz, an insider, and assumed Horowitz's duty not to use what he knew to be nonpublic information for his personal benefit. This is a Dirks approach.

2. Lund could have misappropriated confidential information both from his own company, Verit, and from P&F and thereby acquired the duty to disclose or refrain. This is a Newman approach.

3. Lund might be held to have an independent duty to Horowitz and P&F because Lund had a long-standing relationship with Horowitz, who also served on the Board of Verit.

In considering the third alternative, the court said:

"[A] trust relationship could be implied. Lund was being approached in his capacity as President of Verit, with a deal, and was given sufficient information to evaluate the offer.... [This] could be grounds for implying an independent relationship of trust and a consequent duty between Lund and Horowitz, representing P&F."

E. Duty Arising From Implied Agreements

In Walton v. Morgan Stanley & Co., 623 F.2d 796 (2d Cir. 1980), the plaintiff argued, albeit unsuccessfully, that Morgan Stanley was subject to an implied agreement of confidentiality. Morgan Stanley had been engaged by Kennecott Copper Corporation to find a company Kennecott could acquire. One company Morgan Stanley considered was Olinkraft. Olinkraft's management supplied Morgan Stanley with confidential internal information. Kennecott did not bid for Olinkraft, but two other companies did. After the announcement Morgan Stanley purchased for its own account approximately 150,000 shares of Olinkraft common stock, believing that another competing offer at a higher price would be forthcoming. Subsequently, Morgan Stanley conveyed the confidential information it had previously received from Olinkraft to Johns-Manville, which eventually agreed to acquire Olinkraft at a higher price than the two original bidders. Walton sued derivatively on behalf of Olinkraft, charging Morgan Stanley with breach of a fiduciary duty owed to Olinkraft under state law.

The District Court dismissed the complaint, and the Court of Appeals for the Second Circuit affirmed. The court held that, in the absence of an extraordinary relationship, Morgan Stanley and Olinkraft must be presumed to have dealt at arm's length and that Morgan Stanley did not become a fiduciary to Olinkraft merely by virtue of the receipt of confidential information. In the absence of an express agreement or understanding, the court refused to imply a fiduciary relationship between the parties.

Although this case arose under state law, the decision relied on a federal securities law case, Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275 (2d Cir. 1975). Frigitemp had disclosed information to the Fund when the Fund purchased Frigitemp's debentures. These dealings were at arm's length, the Fund had a right to request the information, and the Fund was under no fiduciary duty to Frigitemp under state law by virtue of its status as a potential purchaser of the corporation's debentures. The Fund was held not to have breached Frigitemp a fiduciary duty when it used the information to purchase Frigitemp common stock.

General Portland, Inc. v. LaFarge Coppee S.A., [current] Fed. Sec. L. Rep. (CCH) ¶99,148 (N.D. Tex. 1983), reached the same decision on similar facts. LaFarge had contacted General Portland about a friendly takeover. The parties entered into a confidentiality agreement relating to an exchange of financial information, which precluded LaFarge from trading in General Portland's securities for a period of time if negotiations were not productive. When negotiations broke down, LaFarge made a public tender offer General Portland stock. The court enjoined LaFarge from proceeding with the tender offer on the basis of a breach of a contractual obligation but did not rule on the issue of whether the contractual breach would constitute a breach of a fiduciary duty arising out of the written agreement.

F. Duty Arising From A Banking Relationship.

Two cases involving banking relationships are worth examining, although they are not insider trading cases. The first is Marrero v. Banco Di Roma (Chicago), [1980] Fed. Sec. L. Rep. (CCH) ¶97,584 (E.D. La. 1980), which enumerated several factors to be considered in determining whether a relationship of trust and confidence, giving rise to a duty to disclose, exists between the parties.

> "Factors to be considered in ascertaining whether such a relationship exists include the parties' relative access to the information, the benefit to be derived by the defendant from the sale, defendant's awareness of the plaintiff's reliance on him in reaching his investment decision, and defendant's role initiating the purchase or sale."

While noting that Marrero might have a difficult time proving a duty to disclose on the part of the bank, the court was unable to conclude as a matter of law that no duty existed and denied a motion to dismiss.

A banking relationship was also examined in Nucorp Energy Securities Ligitation, [current] Fed. Sec. L. Rep. (CCH) ¶99,157 (S.D. Cal. 1983). Continential Illinois National Bank had made loans to various officers and directors of Nucorp, secured by Nucorp stock. Plaintiffs alleged that Contilly had a substantial participation in Nucorp through "ownership" of Nucorp stock, had concealed adverse information about Nucorp, and had arranged a final debenture offering prior to adverse announcements. The court denied a motion to dismiss, refusing to find as a matter of law that the bank had no duty of disclosure.

G. Duty Arising From Statute Or Regulation

Pittsburgh Terminal Corp. v. B&O Railroad Co., 680 F.2d 933 (3d Cir. 1982), found a disclosure duty under Rule 10b-5 arising from the operation of Rule 10b-17. Pittsburgh Terminal Corp. held B&O convertible debentures, convertible any time before maturity into ten shares of B&O common stock. B&O had not paid a dividend in more than 15 years. B&O then declared a dividend payable to shareholders of record as of the date of the announcement. This action deprived debenture holders of the opportunity to convert before the record date and thereby participate in the dividend. The Court of Appeals for the Third Circuit found that Rule 10b-17 (failure to give ten days notice of a record date for a dividend constitutes a manipulative or deceptive device or contrivance as used in Section 10(b)) gave rise to a duty to disclose under Rule 10b-5.

Another case involving a duty based upon statute on regulation is U.S. v. Saunders, 82 Cr. 157 (E.D. Va. 1982). Saunders, a civilian Navy employee, was convicted on two counts of violating a conflict of interest statute, which prohibits federal employees from participating as a government employee in any matter concerning an organization in which they have a financial interest. Saunders participated in the award of a $58 million Navy contract to a subsidiary of Whitehall Corporation. Prior to the announcement of the award of the contract, Saunders purchased 800 shares of the common stock of the company. In August, 1982, Saunders pled guilty of a charge of violation of Rule 10b-5.

III. SOME THOUGHTS ON THE THEORETICAL BASIS OF THE DUTY TO DISCLOSE

Section 10(b) of the Act prohibits the use of "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." Rule 10b-5 prohibits any person from employing "any device, scheme, or artifice to defraud" or from engaging in "any act, practice, or course of business which operates or would operate as a fraud or deceit." For the purpose of insider trading, the fraudulent practice is the nondisclosure of the material, nonpublic information.

The predicate for this statutory prohibition is the common law action of deceit. The interest protected by the law of deceit is that of formulating business judgments without being misled by others -- in short, not being cheated. However, if the misconduct is nondisclosure rather than affirmative misrepresentation, deceit generally has provided no protection. Only if a duty to disclose exists is there liability for nondisclosure. The Restatement (Second) of Torts codifies this concept. Section 551 imposes liability upon a person who fails to disclose "matters known to him that the other [party] is entitled to know <u>because of a fiduciary or other similar relation of trust and confidence between them</u>." (Emphasis added.)

The comment to this section sheds some light on the relationships that may give rise to such a duty:

> "Other relations of trust and confidence include those of the executor of an estate and its beneficiary, a bank and an investing depositor, and those of a physican and patient, attorney and client, priest and parishioner, partners, tenants in common and guardian and ward. Members of the same family normally stand in a fiduciary relation to one another, although it is of course obvious that the fact that two men are brothers does not establish relation of trust and confidence when they have become estranged and have not spoken to one another for many years. In addition, certain types of contracts, such as those of suretyship or guarantee, insurance and joint adventure, are recognized as creating

in themselves a confidential relationship and hence as requiring the outmost good faith and full and fair disclosure of all material facts."

Courts frequently have held that silence operates as a deceptive act or practice under Rule 10b-5 only if there is a duty to speak, consistent with the foregoing approach. Indeed, Chiarella cites Restatement §551. The dissenting opinions in Chiarella, however, argue that the prohibitions of Section 10(b), as applied to nondisclosures, are broader than the common law tort of misrepresentation. Justice Blackmun wrote that "[t]he duty to abstain or disclose arose not merely as an incident of fiduciary responsibility, but as a result of the 'inherent unfairness' of turning secret information to account for personal profit." He argued that the "special facts" doctrine of Strong v. Repide, 213 U.S. 419 (1909), extended common law concepts.

> "Even at common law, however, there has been a trend away from strict adherence to the harsh maxim caveat emptor and toward a more flexible, less formalistic understanding of the duty to disclose. Steps have been taken toward application of the 'special facts' doctrine in a broader array of contexts where one party's superior knowledge of essential facts renders a transaction without disclosure inherently unfair."

The majority in Chiarella rejected this formulation, noting that even the earliest insider trading cases had focused on a "special relationship." Cady, Roberts & Co., 40 SEC 907 (1961) looked "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." (Emphasis added.) Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951), had a similar focus:

> "The rule is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority shareholders without disclosing material facts.... The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority shareholders.... Some courts have called this a fiduciary duty while others state it is a duty imposed by the 'special circumstances'." (Emphasis added.)

Thus, rather than focusing on the informational advantage of one party, early cases such as Cady Roberts and Speed focused on the defendant's relationship giving him access to information. The Chiarella majority opinion is consistent with these early cases, rejecting the notion of the Chiarella dissenters that Rule 10b-5 prohibits any person from exploiting an informational advantage.

Justice Blackmun argued for such a position in his dissent in Chiarella, contending that the "special facts" doctrine of Strong v. Repide supported such an expansion. But Strong v. Repide also can be read as a "traditional" insider trading case. In Repide, a 1909 case, the defendant owned 75% of the stock in a company which had substantial landholdings. Although the land was essentially worthless for commercial purposes, the government was interested in acquiring it for a substantial price. While negotiating a sale to the government, defendant purchased plaintiff's stock without disclosing the potentially greater value of the stock. In finding a duty to disclose, the Court said:

> "If it were conceded, for the purpose of the argument, that the ordinary relations between director and shareholder ... are not of such a fiduciary nature as to make it a duty of a director to disclose to a shareholder the general knowledge which he may possess regarding the value of the shares of the company before he purchases any from a shareholder, yet there are cases where by reason of the special facts, such duty exists." (Emphasis added.)

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> "He [defendant] was not only a director, but he owned three-fourths of the shares of its stock, and was, at the time of the purchase of the stock, administrator general of the company, with large powers.... He was also the chief negotiator for the sale of all the lands, and was acting substantially as the agent of all of the shareholders of his company."

Strong v. Repide thus can be read to hold that a duty to disclose can arise from existing special relationships, as well as for the proposition that a duty to disclose can arise because of special facts known only to defendant.

The duty to disclose issue will come before the Supreme Court once again if it grants the petition for certiorari in U.S v. Newman. The petition argues that Newman's conviction was based improperly upon a federalization of a duty arising under state law, in contravention of Santa Fe Industries, Inc. v. Green, 403 U.S. 462 (1977).* Newman argues that misappropriation of information by an employee traditionally is the province of state law, not Rule 10b-5, and that the Second Circuit's decision has transformed an employee's state law fiduciary obligation to his employer into a new duty under the federal securities law.

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* Santa Fe involved a short-form merger intended to eliminate minority shareholders. Defendants made full disclosure and adequately advised minority shareholders of their appraisal rights under state law. Rather than pursuing appraisal rights, plantiffs sued under Rule 10b-5. In finding no violation of Rule 10b-5, the Court said: "[T]he Court repeatedly has described the 'fundamental purpose' of the Act as implementing a 'philosophy of full disclosure.' ... The language of §10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception....[T]he transaction ... was neither deceptive nor manipulative and therefore did not violate either §10(b) of the Act or Rule 10b-5... [T]he cases [cited by the plantiffs] do not support the proposition adopted by the Court of Appeals below, and urged by respondents here, that a breach of fiduciary duty by majority shareholders, without any deception, misrepresentation, or nondisclosure, violates the statute and Rule.... [W]e are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."

Santa Fe thus apparently holds that violation of Rule 10b-5 occurs only if there is a breach of duty occurring as a result of the misrepresentation, deception, or nondisclosure and that Rule 10b-5 simply does not cover the breach of all fiduciary duties involving securities.

IV. THE POST-CHIARELLA DUTY THEORY IN PRACTICE - WHO ARE THE DEFENDANTS?

The following cases brought by the Commission -- all after Chiarella -- demonstrate the variety of relationships that can give rise to a duty to disclose, notwithstanding Chiarella's seemingly restrictive analysis. Although a few of these cases are still in litigation, most have been settled by consent decrees, and all have as defendants "non-traditional" insiders.

1. Financial Printers

SEC v. Materia, 82 Civil 6225 (S.D. N.Y. Sept. 20, 1982).

The Commission alleged that Materia handled tender offer documents in his job at a printer and, on the basis of information obtained, purchased stock of target companies prior to the announcement of the tender offer.

SEC v. Muth, 82 Civil 7317 (S.D. N.Y. Nov. 4, 1982).

Muth also was employed by a printer. The Commission alleged that he purchased stock in target companies prior to takeover announcements. He consented to an injunction.

2. Consultants

SEC v. Montgomery, 82 Civil 6728 (S.D. N.Y. Oct 12, 1982). The Commission alleged that Montgomery, as a consultant to Celanese Corporation, became aware of acquisition discussions Celanese was conducting. With this information Montgomery purchased stock in the target for a group of relatives, friends, and acquaintances. He consented to an injunction.

SEC v. Dove, 82 Civil 1522 (D.D.C. June 3, 1982). The Commission alleged that Dove, a consultant to the Board of Directors of Advent Corporation, attended Director's meetings and learned of substantial company losses and the possibility of a bankruptcy petition. Dove sold short 16,000 shares of Advent stock. He consented to an injunction.

SEC v. Baranowicz, et. al., 82 Civil 3082-CCH (C.D. Cal. June 21, 1982). The Commission alleged that Michael Chang, a financial consultant to Specialty Restaurants Corporations, purchased common stock of the company prior to the public announcement by the company of a tender offer for its own stock. Chang consented to an injunction.

3. Bankers

SEC v. Cooper, et al., 82 Civil 3462 (C.D. Cal. July 15, 1982). The Commission alleged that Cooper, an assistant vice president of Bankers Trust Company, learned of the proposed acquisition of Brunswick Corporation by one of the bank's customers. He bought common stock and call option contracts for Brunswick common stock. He consented to an injunction.

SEC v. Fabergas, et al., 82 Civil 3440 (C.D. Cal. July 14, 1982). The Commission alleged that Fabergas, a vice president at Credit Suisse, learned of a potential acquisition of Brunswick Corporation by Whittaker as a result of his position as a Credit Suisse account officer for Whittaker. Fabergas purchased 200 call options on the common stock of Brunswick. He consented to an injunction.

4. Government Employee

SEC v. Saunders, 82 Civil 0345-A (E.D. Va. Apr. 19, 1982). The Commission alleged that Saunders, a civilian employee of the Department of the Navy, purchased stock in a company to which he was about to award a substantial Navy contract. He consented to an injunction.

5. Accountants

SEC v. Martin, Civil No. C82-381 (W.D. Wash. Apr. 7, 1982). The Commission alleged that Martin, the personal accountant and financial adviser to an outside director of Sante Fe International Corporation, learned while preparing tax materials for the director that a merger agreement between Santa Fe and Kuwait Petroleum Company was about to be announced. Martin purchased 800 call options on Santa Fe stock. The court has entered an order freezing all profits realized by Martin. An application for a preliminary injunction is pending.

SEC v. Davidowitz, 81 Civil 4857 (S.D. N.Y. Aug. 6, 1981). The Commission alleged that Davidowitz, a partner in a major accounting firm, learned through a client of the firm, Gray Drug Stores Inc., of the possibility of the merger or acquisition of Drug Fair Inc. Davidowitz purchased 11,000 shares of Drug Fair stock. He consented to an injunction.

7. Lawyers

SEC v. Rubinstein, et al., 82 Civil 4043 MEL (S.D. N.Y. June 21, 1982). The Commission alleged that Kenneth Rubinstein, while employed at a New

York law firm, learned of tender offers a number of the firm's clients proposed to make. Rubinstein purchased stock in the target companies prior to the announcements. He consented to an injunction. The Commission also alleged that Rubinstein tipped his brother Aaron, a lawyer at another New York firm. The Commission's complaint against Aaron Rubinstein was dismissed, following a trial on the merits on a finding that the Commission failed to establish that Aaron knew, had reason to know, or acted in reckless disregard of whether the information conveyed by his brother, had been misappropriated or obtained from a corporate "insider."

SEC v. Florentino, 81 Civil 5903 (S.D. N.Y. Sept. 23, 1981). The Commission alleged that Florentino, a lawyer, purchased securities of companies which were subjects of tender offers made by his firm's clients. Florentino consented to an injunction.

SEC v. Cooper, et al., 82 Civil 3462 (C.D. Cal. July 15, 1982). The Commission alleged that Cooper tipped a friend, an attorney in Los Angeles, who purchased Brunswick call options. The attorney tipped his friend, an attorney in Washington, D.C., who also purchased Brunswick call options. Both attorneys consented to an injunction.

8. Unknown Relationships

SEC v. Musella et al., 83 Civil 0342 (S.D. N.Y. Jan. 11, 1983). The Commission alleged that Musella and his associates improperly obtained information regarding tender offers directly or indirectly from a New York law firm. The firm was not named as a defendant in this action. A temporary restraining order has been issued, providing for a temporary freeze of certain assets of Musella.

V. CONCLUSION

Chiarella has been read as substantially narrowing the insider trading proscriptions of Section 10(b) by imposing a duty to disclose only if there is a special relationship between the parties to a transaction. On the basis of a literal reading of Chiarella, one could conclude that Rule 10b-5, as it proscribes insider trading, is limited in its application to a small circle of traditional corporate insiders and persons with established relationships with the company. As the recent cases I have discussed demonstrate, however, both the courts and the Commission have been quite willing to go beyond a literal, restrictive reading of Chiarella. Although a parity of information theory was rejected by Chiarella, the persistent expansion of the duty theory nonetheless necessarily results in a widening circle of persons and entities being placed on a footing of equal information. I therefore would close by observing that this is a hazardous area of the law and that reliance upon a literal, isolated reading of Chiarella may be a serious miscalculation.

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