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CRS REPORT FOR CONGRESS

SECURITIES LAW: ANALYSIS OF CASES CONCERNING INSIDER TRADING UNDER SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934

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May 20, 1987

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ABSTRACT

Discusses major federal cases interpreting the application of the major antifraud provision of the Securities Exchange Act of 1934 to insider trading violations.

SECURITIES LAW: ANALYSIS OF CASES CONCERNING INSIDER TRADING UNDER SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934

The Securities Exchange Act of 1934[1] is concerned with many different areas, such as the creation of the Securities and Exchange Commission,[2] the regulation of publicly-held companies,[3] the regulation of the trading markets,[4] and the ongoing process of disclosure to the investing public through the filing of periodic and updated reports with the Commission.[5] Any issuer which has a class of securities traded on a national securities exchange or total assets exceeding $1,000,000 and a class of equity shareholders with at least 500 or 750 shareholders, depending on the date, must register with the Commission.[6] Annual reports and other reports as required by the Commission must be filed under the provisions of this Act.[7]

Section 10(b) of the 1934 Act 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 or any national securities exchange –
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> . . .
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> (b) To use or employ, in connection with the

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[1] 15 U.S.C. §§ 78a *et seq.*

[2] 15 U.S.C. § 78d.

[3] 15 U.S.C. § 78*l*-78o.

[4] 15 U.S.C. § 78g-78i.

[5] 15 U.S.C. § 78m.

[6] 15 U.S.C. § 78*l*.

[7] 15 U.S.C. § 78m.

> 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.[8]

In order to comply with the requirement that rules be promulgated to implement this provision, the SEC adopted rule 10b-5:

> 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 or any national securities exchange,
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> (1) to employ any device, scheme, or artifice to defraud,
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> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or
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> (3) to engage in any act, practice, or course of business which operates as a fraud or deceit upon any person,
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> in connection with the purchase or sale of any security.[9]

It should be emphasized that neither the statute nor rule 10b-5 anywhere explicitly prohibits insider trading. However, in the approximately forty years since the rule's adoption, it has been invoked in countless proceedings involving many different situations; one of its most important uses has been as a sanction against those who trade securities with the advantage of inside information. Thus, case interpretations of the statute and the rule set forth the parameters of their application to insider trading.

Early application of the federal statute and rule supplemented state

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[8] 15 U.S.C. § 78j(b).

[9] 17 C.F.R. § 240.10b-5.

common law, which often was not able to remedy a seller whose shares were purchased by people with inside information. The 1947 decision of Kardon v. National Gypsum Co.[10] was one of the first cases to imply a private right of action under rule 10b-5. The case concerned the purchase of shares by directors from shareholders after the directors had already made plans to sell the assets of the corporation for a substantial profit. Four years later in Speed v. Transamerica Corp.[11] a majority shareholder of company "A" was held liable for purchasing shares in company "B" without disclosing that company "B"'s inventory was worth substantially more than the annual report indicated and that company "A" intended to merge with company "B."

Cases in the 1960's and early 1970's expanded the application of section 10(b) and rule 10b-5. Three important decisions illustrating this are In the Matter of Cady, Roberts & Co.,[12] SEC v. Texas Gulf Sulphur Co.,[13] and In the Matter of Investors Management Co.[14]

In Cady, Roberts a partner in a brokerage firm, after receiving a message from a director of Curtiss-Wright that the board of directors had voted to cut the dividend, placed orders to sell some of the stock before news of the dividend cut was disseminated to the public. The SEC found that the broker's conduct violated at least clause (3) of the rule in that it operated as a fraud or deceit upon the purchasers and that there was no need to decide the scope of

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[10] 73 F.Supp. 798 (E.D. Pa. 1947)

[11] 99 F.Supp. 808 (D. Del. 1951).

[12] 40 S.E.C. 907 (1961).

[13] 401 F.2d 833 (2d Cir. 1968), cert. denied sub nom. Coates v. SEC, 394 U.S. 976 (1969).

[14] 44 S.E.C. 633 (1971).

clauses (1) and (2). In determining that there was a violation of clause (3), the Commission appears to have found fraud or deceit committed both on the company and on persons on the other side of the market:

> [T]he 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.[15]

The SEC rejected the broker's argument that the obligation to disclose material information exists only in a situation involving face-to-face dealings:

> It would be anomalous indeed if the protection afforded by the anti-fraud provisions were withdrawn by transactions effected on exchanges, primary markets for securities transactions. If purchasers on an exchange had available material information known by a selling insider, we may assume that their investment judgment would be affected and their decisions whether to buy might accordingly be modified. Consequently, any sales by the insider must await disclosure of the information.[16]

Thus, this case established that rule 10b-5 extends beyond officers, directors, and major stockholders to anyone who receives information from a corporate source.

Texas Gulf Sulphur involved corporate officers and employees who made large purchases in the company's stock after learning that exploratory drilling on one of the company's properties indicated the discovery of large amounts of copper, zinc, and silver ores. Since at the time that the trading occurred the drilling had not established that the ore was commercially mineable, the

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[15] 40 S.E.C., at 912.

[16] 40 S.E.C., at 914.

defendants argued that the inside information on which they had traded was not material. However, the court held that the test of materiality was not whether the company would be permitted to disclose the information if it were selling securities but rather whether the information was the type that might affect the judgment of reasonable investors. The court found here that the size and timing of defendant's purchases were evidence of the materiality of the discovery. The court went on to find that an insider is anyone in possession of material inside information and may be liable for a 10b-5 violation if he trades with this information. A person in possession of inside information must either disclose it to the investing public or, if he cannot disclose it because he must protect corporate confidences or if he chooses not to disclose it, he must abstain from trading in or recommending securities concerned while the inside information remains undisclosed.

In Investors Management an aircraft manufacturer disclosed to the broker-dealer acting as principal underwriter for a proposed debenture issue that its yearly earnings would be substantially below what it had publicly forecast. The underwriting department of the broker-dealer passed this information to its sales department which in turn passed it to the representatives of major institutional clients. As a result, the institution sold large amounts of the stock before the public disclosure of the revised earnings estimate. Although the defendants argued that this information was public because it had circulated as a rumor, the SEC held that the inside information received by the defendants was different from the rumor in that it was more specific and more trustworthy. Investors Management established the liability of the indirect tippee and rejected the argument that the tippee must have actual knowledge that the information was disclosed in a breach of fiduciary duty in order to violate rule 10b-5. The court held that the rule was violated when the tippee knew or had reason to know that the information was non-public and had been obtained improperly.

The principles of common law fraud and deceit, on which bases rule 10b-5 is worded, include the following elements: 1) false representation of fact; 2) knowledge by the defendant that the representation is false (scienter); 3) intention by the defendant to induce the plaintiff to act; 4) justifiable reliance by the plaintiff; and 5) damage to the plaintiff.[17] Some of the court cases appear to have diluted these requirements for purposes of civil liability involving rule 10b-5.

The plaintiff in List v. Fashion Park[18] authorized his brother to sell shares at not less than $18 per share. The defendant purchased the shares at $18.50 through his own broker. The plaintiff alleged in the 10b-5 suit that the defendant had failed to disclose that he was a director of the company and that merger negotiations, which would result in a higher price for the stock, were pending. Although the court denied recovery for the plaintiff, it did state that, in order to recover, the plaintiff did not have to show affirmative misrepresentation; instead, non-disclosure of the type here was sufficient to prove the violation of clause 3 of rule 10b-5. Further, reliance by the plaintiff exists when the plaintiff can show that the undisclosed facts would have affected his judgment.

Affiliated Ute Citizens v. United States[19] illustrates a further dilution of the common law requirements. In this case defendants had purchased shares

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[17] See W. Prosser and W. Keeton, Torts, p.728 (5th ed. 1984).

[18] 340 F.2d 457 (2d Cir. 1965).

[19] 406 U.S. 128.

of the Ute Development Corporation from members of the tribe without telling them that at that time the shares were trading at higher prices in another market. The Court held that the defendants did not have the right to remain silent:

> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. See Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384 (1970); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (CA2 1968), cert. denied sub nom. Coates v. SEC, 394 U.S. 976 (1969); 6 L. Loss, Securities Regulation 3876-3880 (1969 Supp. to 2d ed. of Vol. 3); A. Bromberg, Securities Law, Fraud-SEC Rule 10b-5, §§ 2.6 and 8.6 (1967). This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact. Chasins v. Smith, Barney & Co., 438 F.2d at 1172.[20]

The application of 10b-5 was expanded further in the case Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.[21] In this case liability was imposed on a tipper and tippees by using the "duty to the entire marketplace" theory. The court found the defendants liable not only to the actual purchasers of the shares but also to all purchasers in the market during the entire period during which the defendants were selling and until dissemination of the information to the public had occurred.

Since approximately 1975, however, there has been a trend toward a more narrow reading of the terms of rule 10b-5. In Ernst & Ernst v. Hochfelder[22]

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[20] 406 U.S., at 153-154.

[21] 495 F.2d 228 (2d Cir. 1974).

[22] 425 U.S. 185 (1976).

the Supreme Court held that fraud does not include overreaching by a controlling shareholder unless there is actual deception and that there must be scienter in order to hold a person liable for damages under rule 10b-5. The Supreme Court also held in Blue Chip Stamps v. Manor Drug Stores[23] that only a purchaser or seller has a private right of action under the rule. Other cases also illustrate a trend toward reimposing the common law requirements for fraud in finding civil liability involving rule 10b-5.

Chiarella v. United States[24] alleged a violation of rule 10b-5 by an employee of a financial printer. The employee, who was involved in printing materials related to corporate takeover bids, deduced the names of the target companies from information contained in documents delivered to the printer by acquiring companies. Without disclosing his knowledge, the employee purchased stock in the target companies and sold the shares immediately after the information was made public, realizing a profit of $30,000. The lower courts found a violation of rule 10b-5 and convicted the employee of the print company for willfully failing to inform the sellers of the target company securities that he knew of an imminent takeover bid that would increase the value of their stock.

However, the Supreme Court reversed the lower courts' decisions, finding that, for there to be a fraud actionable under 10b-5, there must be a duty to disclose arising from a relationship of trust and confidence between parties to the transaction. In this situation the employee did not have a duty to disclose the information: he was not a corporate insider, he received no confidential information, nor did any duty arise from the relationship between

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23 421 U.S. 723 (1975).

24 445 U.S. 222 (1980).

the printing company employee and the sellers of the target companies' securities. The Court held that a duty to disclose under section 10(b) does not arise from the mere possession of nonpublic market information.

One year later a question which was not answered in Chiarella was addressed in United States v. Newman.[25] This case concerned whether insider trading sanctions under rule 10b-5 still reached persons who were not insiders of the companies whose securities were traded. The defendants included employees of investment banking firms which were advising and representing companies planning to make tender offers. These defendants had secretly traded on the basis of that information and had realized profits because the market price of the target company stocks had increased substantially after the offers were announced. The Second Circuit ruled that the defendants had defrauded their employers by trading on the basis of client confidences. The court further held that these clients had been wronged because their "takeover plans were keyed to target-company stock prices [which were] not artificially inflated through purchasers by purloiners of confidential information."[26]

The holding of the Newman case, when compared with the holding of a Second Circuit decision just a few months earlier, seems to confuse the notion of just exactly when one may be held liable under 10(b) if he uses inside information to trade. The earlier case, Walter v. Morgan Stanley & Co.,[27] concerned whether an investment banking firm's receipt of confidential information from a target company during preliminary negotiations with a possible merger partner precluded later use of that information by the investment banking firm in

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25 664 F.2d 12 (2d Cir. 1981), cert. denied 464 U.S. 863 (1983).

26 664 F.2d, at 17.

27 623 F.2d 796 (2d Cir. 1980).

purchasing for its own account and in giving advice to another client. The court held in this case that the receipt of information from a company by a person dealing with the company at arms' length did not prohibit the recipient from trading on that information.

The 1983 Supreme Court case Dirks v. SEC[28] is further indication that the Supreme Court may at the present time somewhat narrowly view the application of section 10(b) and rule 10b-5. Dirks involved an officer of a broker-dealer who specialized in providing investment analysis of insurance company securities to institutional investors. He received information that the assets of an insurance company were greatly overstated because of fraudulent corporate practices and that regulatory agencies had not acted on these charges made by company employees. Although the officer of the broker-dealer did not himself trade the stock, some of his customers did, based upon informtion which they received from him. The price of stock fell, and the SEC began investigations, eventually finding that the officer had violated 10b-5 by repeating the allegations of fraud to investors who later sold their stock in the insurance company. However, because of his role in uncovering the fraud, he was only censured by the Commission.

The Supreme Court found that no violation of 10(b) had occurred. In order to establish a violation of 10(b) by a corporate insider, two elements are necessary: the existence of a relationship affording access to include information intended to be available only for a corporate purpose and the unfairness of allowing a corporate leader to take advantage of that information by trading without disclosure. However, the duty arises from a fiduciary relationship, and, further, there must be manipulation or deception to bring

[28] 463 U.S. 646 (1983).

about a breach of the fiduciary duty. Here, the insider did not trade on the inside information, nor did he make secret profits.

For tippees to have the duty to disclose inside information or to abstain from trading, according to the Court in Dirks, there must be a breach of the insider's fiduciary duty. Since the officer did not have the duty to abstain from use of the inside information, he had no pre-existing fiduciary duty to the insurance company's shareholders; therefore, they did not breach rule 10b-5. Although the case left open the question of imposition of liability on certain groups of people, its footnote fourteen suggested that the concept of insider is not necessarily limited to officers and directors; it also includes persons who come into possession of confidential information while performing services on behalf of the corporation.

Despite the Supreme Court decisions in Chiarella and Dirks which somewhat limited the application of section 10(b) and rule 10b-5, some of the later lower-court decisions may have further expanded their application. The first reported decision after Dirks concerning insiders was SEC v. Lund.[29] This case involved the disclosure of a corporation's intended business opportunity to a prospective joint venturer. Although the defendant at the time was not actually a fiduciary of the corporation, he was, according to the court, a temporary insider of the corporation because of his special relationship. SEC v. Musella[30] and SEC v. Materia,[31] both decided by the Southern District of New York, involved cases brought by the SEC against employees of a financial

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[29] 570 F.Supp. 1397 (C.D. Cal. 1983).

[30] 578 F.Supp. 425 (S.D.N.Y. 1984).

[31] CCH Fed. Sec. L. Rep. Par. 99,526 (S.D.N.Y. 10-14-83), aff'd 745 F.2d 197 (2d Cir. 1984), cert. denied 105 S.Ct. 2112 (1985).

printer and a law firm who traded on nonpublic information concerning imminent tender offers. Both of these decisions applied the misappropriation of information theory and found the proscriptions of 10b-5 to be satisfied because of a breach of duty to the employers. These three decisions may be somewhat difficult to reconcile with Dirks and Chiarella because liability appears in these three later cases to have been imposed on the basis of receiving the information and not on the basis of a separate and pre-existing fiduciary relationship, as required by the Supreme Court cases.

This possible discrepancy may be clarified by a case presently before the Supreme Court.[32] R. Foster Winans, formerly the writer for the Wall Street Journal's "Heard on the Street" column, and two associates were charged with insider trading violations in using advance knowledge of information which would later appear in the column to trade stocks and options. They had allegedly engaged in scalping, a practice in which a person who is able to influence investors purchases a security, then recommends it, and sells it after it appreciates in value. This case is the government's first attempt to extend rule 10b-5 to impose criminal liability on a reporter who traded not on inside information but rather on the expectation that his article would influence the market. In arriving at a decision in this case, the Supreme Court likely will have to decide whether and to whom Winans owed a fiduciary duty. Such a fiduciary duty could be owed to the readers of the column, the sellers of the stock, the market in general, or to his employer, the Wall Street Journal. Certainly, Winans was not a traditional insider in that he himself was not trading on the basis of his receipt of information; rather, he

[32] United States v. Winans, 612 F.Supp. 827 (S.D.N.Y 1985), aff'd in part, rev'd in part sub nom. United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), cert. granted, No. 86-422, 55 U.S.L.W. 3420 (U.S. Dec. 16, 1986).

and others were trading on the perceived effect that his column would have on the market in general. However, this case might make use of the misappropriation theory in finding that Winans owed a fiduciary duty to his employer -- that, in fact, this information belonged to the Wall Street Journal and that he was not free to use it for his personal gain in any way.

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