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Securities Regulation-Federal Anti-Fraud Provisions-Applicability of Insider Responsibility to Broker in Possession of Inside Corporate Information

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SECURITIES REGULATION—FEDERAL ANTI-FRAUD PROVISIONS—APPLICABILITY OF INSIDER RESPONSIBILITY TO BROKER IN POSSESSION OF INSIDE CORPORATE INFORMATION—During a period of upward movement in the price of Curtiss-Wright common stock, the corporation's board of directors voted to reduce the stock dividend by forty percent, an action certain to have an immediate adverse effect upon the stock's market price. Although the board immediately authorized the transmission of information concerning its action to the New York Stock Exchange,[1] an inadvertent delay of forty-five minutes ensued. Unaware of the delay, *C*, a director of Curtiss-Wright and a registered representative of Cady, Roberts & Co. (registrant), a registered broker-dealer,[2] telephoned registrant to inform *G*, one of its partners, of the dividend reduction. *G*, knowing that this information had not yet been publicized, took advantage of his knowledge by quickly selling on the New York Stock Exchange 9,700 shares of the Curtiss-Wright stock for the discretionary accounts of his customers. Thirty minutes later the news of the dividend reduction reached the Exchange and the price of Curtiss-Wright stock immediately dropped by almost four points. The Securities and Exchange Commission instituted disciplinary proceedings against *G* and registrant to determine whether the sale violated the federal "anti-fraud" provisions:[3] section 17(a) of the Securities Act of 1933,[4] section 10(b) of the Securities Exchange Act of 1934[5] and rule 10b-5.[6] *Held*, both *G* and registrant[7] are subject to sanctions[8] for willfully violating these provisions. Although the "anti-fraud" provisions have traditionally imposed a duty of disclosure upon "insiders," they also are applicable to any person enjoying a special relationship whereby he has access to confidential corporate information. *Cady, Roberts & Co.*, SEC Security Exchange Act Release No. 6668 (Nov. 8, 1961), CCH 1961 FED. SEC. L. REP. ¶ 76803.

At common law a private investor ordinarily had no duty to disclose material information in his possession that might affect the price of stock

1 The Exchange requires an immediate public release of dividend information by an issuer. Article III(4), Form of Listing Agreement, NEW YORK STOCK EXCHANGE MANUAL A-28 (1953).

2 Registrant was registered in compliance with the Securities Exchange Act of 1934, § 15(b), amended by 52 Stat. 1070 (1938), 15 U.S.C. § 78o—3 (1958).

3 The case was heard under an offer of settlement that stipulated as to both the facts and the penalty. Administrative Procedure Act § 5(b), 60 Stat. 239 (1946), 5 U.S.C. § 1004(b) (1958); SEC Rules of Practice, 17 C.F.R. § 201.8 (Supp. 1962).

4 48 Stat. 84 (1933), 15 U.S.C. § 77q (1958).

5 48 Stat. 891 (1934), 15 U.S.C. § 78j (1958).

6 17 C.F.R. § 240.10b-5 (1949).

7 Registrant was found to be in violation because G acted in connection with his duties as a partner of registrant. See H. F. Schroeder & Co., 27 S.E.C. 833 (1948).

8 The SEC accepted G's and registrant's offer of settlement which provided that G be suspended from the New York Stock Exchange for twenty days and that no action be taken against registrant.

involved in a transaction to which he was a party.[9] Of greater importance, perhaps, was the status of corporate "insiders" (*e.g.*, directors, officers and controlling shareholders[10]) who utilized corporate information in such transactions. In a majority of states there was no duty for an "insider" to disclose such information to the other party to the transaction, although he was considered to be liable to the corporation for his action.[11] Even in the "minority rule" [12] and "special facts"[13] jurisdictions, where there was a duty to disclose, breach of which would render the insider liable for damages to the defrauded party, only a defrauded vendor[14] who did not sell on an exchange[15] could hope to prevail. The net result of this diversity at the common law was that private investors were not fully protected from misuse of information by insiders. Partially in recognition of this, Congress enacted securities legislation designed to impose sanctions against abuse of position by insiders and to encourage a wider dissemination of information concerning corporate activity and financial status.[16]

Probably the most effective and encompassing federal weapon resulting from the securities legislation is rule 10b-5.[17] Its terms are almost identical to those of section 17 (a) of the Securities Act of 1933, although it supplements that section by prohibiting fraudulent conduct in purchases as well as sales of securities. It has often been recognized that rule 10b-5 is not limited by common law standards of what constitutes fraud.[18] Certainly, it imposes upon an insider a duty to disclose material corporate information when dealing in that corporation's stock.[19] On the other hand, a

9 3 Loss, SECURITIES REGULATION 1430-33 (2d ed. 1961).

10 While most common law cases dealt with directors and officers, recent cases under federal legislation also recognize the controlling shareholder as an insider. *E.g.*, Perlman v. Feldmann, 219 F.2d 173, 176 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955); Zahn v. Transamerica Corp., 162 F.2d 36, 42 (3d Cir. 1947).

11 *E.g.*, Carpenter v. Danforth, 52 Barb. 581 (N.Y. Sup. Ct. 1868).

12 *E.g.*, Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903).

13 *E.g.*, Strong v. Repide, 213 U.S. 419 (1909).

14 No cases can be found at the common law imposing liability on a selling insider who would otherwise have a duty to disclose. 3 Loss, SECURITIES REGULATION 1454-55 (2d ed. 1961).

15 Goodwin v. Aggasiz, 283 Mass. 358, 186 N.E. 659 (1933).

16 See H. R. REP. No. 1383, 73d Cong., 2d Sess. 13 (1934); S. REP. No. 792, 73d Cong., 2d Sess. 9 (1934); S. REP. No. 1455, 73d Cong., 2d Sess. 55, 68 (1934).

17 17 C.F.R. § 240.10b-5 (1949). "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

18 *E.g.*, Norris & Hirshberg, Inc. v. SEC, 177 F.2d 228, 233 (D.C. Cir. 1949).

19 Speed v. Transamerica Corp., 99 F. Supp. 808, 828-29 (D. Del. 1951), *aff'd on rehearing*, 100 F. Supp. 461 (D. Del. 1951), 103 F. Supp. 47 (D. Del. 1952). It is well

subject of frequent speculation has been whether—and to what extent—rule 10b-5, phrased in terms of "any person," imposes upon outsiders the insider's duty to disclose material information.[20] Clearly, both outsiders and insiders are within the scope of rule 10b-5 (b) when there have been representations and statements incident to fraudulent conduct.[21] However, problems arise when, as in the principal case, there has been *silence* in connection with a transaction.[22] With respect to this problem, it has been held that a broker who knows of an insider's scheme to defraud the public must disassociate himself from the transaction or be liable for fraud under rule 10b-5.[23] Moreover, there has been some indication that an outsider who gains access to confidential inside information as a result of business negotiations or transactions with a corporation becomes subject to a duty to disclose this information when dealing with that corporation's stock.[24] Nevertheless, until the principal case, the issue raised by an outsider's use of inside corporate information had not been squarely faced.[25]

In the principal case the SEC, in finding that G, an outsider, had violated the federal "anti-fraud" provisions, was content to base its analysis on the language of rule 10b-5 (c), which provides that it shall be unlawful for any person "to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person . . . ."[26] The Commission pointed out that the statutory duty to disclose, although traditionally applied to insiders, entailed two important elements: (1) the existence of a special relationship giving access, directly or indirectly, to information intended for a corporate purpose rather than for anyone's personal benefit; and (2) the inherent unfairness involved in using such information when dealing with another.[27] The fact that C was connected with Curtiss-Wright as a director and with G's firm as a registered repre-

settled that a defrauded investor can base a civil action for damages on rule 10b-5. Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa. 1947); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961). It must nevertheless be shown that the plaintiff was directly injured by the wrongdoer as the result of a stock transaction. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

20 *E.g.*, Comment, 59 YALE L.J. 1120 (1950); Note, 39 CALIF. L. REV. 429 (1951).

21 3 Loss, SECURITIES REGULATION 1445 n.1 (2d ed. 1961).

22 In regard to liability under rule 10b-5 (a), one court commented that "silence cannot be deemed to be the employment of 'any device, scheme or artifice'. . . ." Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701, 706 (S.D.N.Y. 1951), *aff'd*, 198 F.2d 883 (2d Cir. 1952).

23 Fry v. Schumaker, 83 F. Supp. 476, 478 (E.D. Pa. 1947); *cf. In re* Hughes & Treat, 22 S.E.C. 623, 626 (1946).

24 Ward La France Truck Corp., 13 S.E.C. 373 (1943) (investigation report).

25 Fry v. Schumaker, 83 F. Supp. 476 (E.D. Pa. 1947) (elements of common law fraud present); Ward La France Truck Corp., *supra* note 24 (investigation report); *cf.* Alexander Smith, 22 S.E.C. 13 (1946).

26 Principal case, CCH 1961 FED. SEC. L. REP. ¶ 76803, at 81017.

27 *Ibid.*

sentative was deemed to put *G* in the position of having such a "special relationship" making him privy to Curtiss-Wright's internal affairs, while *G*'s use of the information transmitted by *C* was considered sufficiently unfair to impose sanctions. Indeed, the SEC considered the unfairness so great that the only available alternative to disclosure of confidential information was found to be a complete cancellation of the transaction.[28]

It is clear that the principal case establishes a new standard for promoting and enforcing fair dealing in stock transactions. However, the future effectiveness of this policing device rests in large part upon the meaning of the "special relationship" concept and the limits on the standard which might be imposed by it. The problem can be illustrated by examining the limitations of the concept. If, for example, an employee of a corporation did work that put him in contact with confidential information it is likely that his employment relationship would subject him to the obligations of rule 10b-5.[29] The apparent liability of an outsider who transacts business with a corporation and picks up confidential information in the process has already been discussed, and this, too, appears to be a "special relationship." Moreover, the SEC would likely be unwilling to allow a member of an insider's family to exploit information in a manner prohibited to the insider himself.[30] The more difficult task comes in applying the requirement of a "special relationship" to an outsider who has no employment, business or family connections with a corporation or its insiders. For example, what if the corporate director in the principal case had not been associated with registrant, the facts merely indicating a friendly call to *G*? Absent the business ties, it would be stretching the term "special relationship" to its conceptual limits to apply it to a relationship based solely on personal friendship.[31] Even more extreme is the situation where an outsider has gained confidential information as a result of overhearing a conversation between insiders. Here there would clearly be no "special relationship" to bring the outsider within the holding of the SEC in the principal case. Yet, the language of rule 10b-5 is broad in scope: "any person" who engages in "any" act or practice resulting in fraud or deceit has thereunder acted unlawfully. Thus, it is submitted that even in the absence of a "special relationship" it would be unlawful for an outsider to utilize confidential information without disclosure. The essential factor is the possession of confidential information by an outsider rather

28 *Ibid.*

29 *Cf.* Brophy v. Cities Serv. Co., 31 Del. Ch. 241, 70 A.2d 5 (1949) (employee liable to corporation). *But see* Stout v. Cunningham, 33 Idaho 464, 196 Pac. 208 (1921).

30 See *In re* Midland United Co., 159 F.2d 340 (3d Cir. 1947) (wife); Berner v. Equitable Office Bldg. Corp., 175 F.2d 218 (2d Cir. 1949) (brother-in-law). See also *In re* Calton Crescent, 173 F.2d 944, 951 (2d Cir. 1949), *aff'd sub nom.* Manufacturer's Trust Co. v. Becker, 338 U.S. 304 (1949).

31 *But see* RESTATEMENT, RESTITUTION § 201 (2) (1937).

than the existence of a "special relationship." This is not to contend, as respondents apparently did,[32] that the duty to disclose would be extended to include information gleaned by an outsider through independent market analysis. The SEC made it clear that information intended only for corporate purposes must have reached the outsider directly or indirectly from a corporation source before any duties under rule 10b-5 would arise.[33]

The main problem confronting the SEC would then appear to be proving that the outsider in fact obtained and used specific confidential corporate information in the transaction in question. This was not a problem in the principal case since there was an offer of settlement in which the respondents submitted a conclusive statement of facts indicating that *C* passed confidential information to *G*. However, in the face of denials by the parties that any such conduct occurred, the difficulties involved in acquiring direct proof of wrongdoing could provide a substantial barrier to enforcement. The crucial issue for the future, therefore, appears to revolve around the effect that will be given to circumstantial evidence of fraudulent conduct. The evidentiary difficulties are well illustrated by the facts of the principal case, which revealed that *before* the Curtiss-Wright board of directors voted to reduce the stock dividend, *G* had already sold 6,500 shares of Curtiss-Wright stock as a result of an earlier decision to liquidate that stock from his discretionary accounts. Certainly, the further sale by *G* of another 9,700 shortly *after* the board's decision would not be as clearly tinged with fraud as when no sales had previously been made. In a similar vein, it would seem that when a member or representative of the alleged wrongdoer firm is also a member of the involved corporation's board of directors, there would be a stronger presumption of fraud. Nevertheless, the Supreme Court has indicated that the association of a director with a brokerage partnership does not impute the director's knowledge of corporate affairs to the partnership simply because it deals in the corporation's securities.[34] Thus, notwithstanding the fact that rule 10b-5 has given the SEC an impressive vehicle for promoting and enforcing fair dealing in securities transactions, the future effectiveness of the Commission's ruling in the principal case may well depend on the standards of proof which will be required thereunder.

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[32] Brief for Respondent, pp. 28-29, principal case.

[33] Principal case, CCH 1961 FED. SEC L. REP. ¶ 76803, at 81017.

[34] Blau v. Lehman, 368 U.S. 403 (1962); see Rattner v. Lehman, 193 F.2d 564 (2d Cir. 1952).