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Securities Legislation - Limitations Upon the Scope of Rule X-10B-5

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SECURITIES LEGISLATION—LIMITATIONS UPON THE SCOPE OF RULE X-10B-5 —A syndicate attempted to acquire all of the outstanding stock in a bridge corporation pursuant to a plan to transfer the stock to a bridge commission and realize substantial returns. The price offered for the stock was well over the market price but the resale plan was not disclosed. After control of 80 percent of the stock was obtained, the syndicate's purchasing agents were installed as officers and directors. They continued to purchase the stock without revealing the plan and the anticipated profits.[1] Upon the completion of the plan, former stockholders in the corporation brought a class action against the syndicate members alleging a violation of rule X-10B-5 of the Securities and Exchange Commission because of the failure of the defendants to disclose the intention to resell. On defendants' motion for summary judgment, *held,* motion granted. The scheme was conceived and prosecuted by outsiders upon whom there was no duty of disclosure. Further, no such duty arose when defendants achieved control of the corporation since they gained no new information by virtue of achieving this position. *Mills v. Sarjem Corp.,* (D.C. N.J. 1955) 133 F. Supp. 753.

Rule X-10B-5, formulated by the Securities and Exchange Commission in 1942, prohibits fraud by any person in connection with the purchase or sale of any security.[2] This broad language, coupled with the possibility of

[1] The complicated transaction is described at length in Driscoll v. Burlington-Bristol Bridge Co., 8 N.J. 433, 86 A. (2d) 201 (1952).

[2] SEC Release No. 3230, 2 CCH Fed. Sec. L. Serv. ¶25,375 (1942): "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,

"(1) to employ any device, scheme, or artifice to defraud,

"(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 the circumstances under which they were made, not misleading, or

"(3) 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."

The rule was promulgated pursuant to §10(b) of the Securities Exchange Act of 1934. 48 Stat. L. 891, 15 U.S.C. (1952) §78(j).

civil recovery,[3] has provoked a great deal of litigation in recent years.[4] By reading limitations into the rule, however, the courts have considerably narrowed its potential scope. For example, the more remote implications are eliminated by requiring "a semblance of privity" between the parties.[5] Although this limitation has been severely criticized as unwarranted by authority,[6] inconsistent with the objectives of the Securities Acts,[7] and unfortunate because of the archaic and ambiguous nature of the term "privity,"[8] it appears to be firmly established.[9] However, it is unlikely that strict privity of contract is necessary. Reliance upon a misrepresentation by a person whom the defendant intended to mislead should be sufficient to create liability.[10] In any event, the requirement cannot be found in the language of the rule. The most troublesome area covered by rule X-10B-5 is that of non-disclosure of pertinent information by corporate "insiders."[11] The leading case holds that it is unlawful for an insider to purchase stock without disclosing material facts affecting its value known to him by virtue of his inside position.[12] In the principal case, the court draws negative inferences from this statement and uses it to set the boundaries of recovery. Thus, *only* insiders are under a duty to disclose and the information *must* be gained by virtue of their inside position. This dubious reasoning does violence to the rule in that it makes it applicable to far fewer persons than the phrase "any person" indicates.[13] Nevertheless, the considerations behind this result are highly practical. Realizing the speculative nature of stock transactions and the necessary differences of opinion between buyer and seller, the principal case allows interference only where the parties are not at arm's length, i.e., where

3 The leading case recognizing such recovery is Kardon v. National Gypsum Co., (D.C. Pa. 1946) 69 F. Supp. 512 (motion to dismiss), (D.C. Pa. 1947) 73 F. Supp. 798 (on the merits), (D.C. Pa. 1947) 83 F. Supp. 613 (requests for additional findings). See 14 UNIV. CHI. L. REV. 471 (1947). The implications of the Kardon case are analyzed in Loss, SECURITIES REGULATION 1052 (1951).

4 See, generally, 59 YALE L. J. 1120 (1950).

5 Joseph v. Farnsworth Radio and Television Corp., (D.C. N.Y. 1951) 99 F. Supp. 701 at 706, affd. per curiam (2d Cir. 1952) 198 F. (2d) 883.

6 See the dissenting opinion of Judge Frank in the court of appeals decision in Joseph v. Farnsworth Radio and Television Corp., note 5 supra. See also 4 STAN. L. REV. 308 (1952).

7 See 4 STAN. L. REV. 308 at 311 (1952); 32 TEX. L. REV. 197 at 207 (1953). The question is also discussed in Loss, SECURITIES REGULATION 1064, n. 404 (1951; Supp. 1955).

8 See Latty, "The Aggrieved Buyer or Seller or Holder of Shares in a Close Corporation under the S.E.C. Statutes," 18 LAW & CONTEM. PROB. 505 at 520 (1953).

9 See Donovan Inc. v. Taylor, (D.C. Cal. 1955) 136 F. Supp. 552, for a recent decision recognizing the privity requirement.

10 To this effect, see Latty, "The Aggrieved Buyer or Seller or Holder of Shares in a Close Corporation under the S.E.C. Statutes," 18 LAW & CONTEM. PROB. 505 at 520 (1953).

11 See Loss, SECURITIES REGULATION 824 (1951). There has been much comment on this question. See e.g.: 39 CALIF. L. REV. 429 (1951); 40 MINN. L. REV. 62 (1955).

12 Speed v. Transamerica Corp., (D.C. Del. 1951) 99 F. Supp. 808. For a history of the Transamerica litigation, see 54 MICH. L. REV. 971 (1956).

13 See 44 ILL. L. REV. 841 (1949), for a discussion of the meaning of "any person."

there is an unfair advantage taken by one because of his access to information.[14] The necessity for such a strained interpretation results from the sweeping, all-inclusive language of rule X-10B-5. The principal case illustrates a process by which the rule is being cut down to manageable proportions. Liability is still recognized in cases containing traditional elements such as privity or fiduciary relationship. To extend it beyond those limits, a more precise statement than rule X-10B-5 will be necessary.

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[14] Principal case at 764.