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An "Unfair Trade" Approach to Securities Regulation—A Reappraisal of Common Law in Light of Equity Funding

Section 10(b) of the 1934 Securities Exchange Act and Rule 10b-5 thereunder were initially based upon common law theories of fraud and deceit when adopted. Their language, however, was made general so as to avoid restrictive application and to enable them to develop along with the needs of security trading and the imaginative minds of those who would certainly try to circumvent their effects. Given this common law mooring, the courts apparently were reticent in applying the law to circumstances not contemplated at the time of the enactment and promulgation. Consequently, the courts fell back upon the common law notions of fraud to support the innovative rulings they considered called for by the remedial policies of the Act and the broad language used in both the Statute and Rule.

To an extent, this reliance was made possible by the contemporaneous liberalization in concepts of common law fraud and in some ways by the retention of common law elements which had utility for modern day securities regulation. However, in many instances the use of some elements was possible only by distorting them. Where this is the case, the use of their labels and modified meanings has caused unnecessary limitations upon further extension of 10b-5 due to the courts' hesitancy to distort the elements of fraud further or to dispense with them entirely.

Currently, the courts are being asked to further define the scope of the Statute and Rule with regard to hitherto unlitigated situations. As to these cases, the role common law elements of fraud will play is uncertain, thereby leaving the law uncertain. These cases, then, lying at the outer extreme of the present scope of 10b-5, provide an op-

1. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1964) [hereinafter cited as the 1934 Act and 10(b), respectively]; 17 C.F.R. 240.10b-5 (1973) [hereinafter cited as Rule 10b-5 or 10b-5].
portunity for the courts to remove those distorted elements which are unnecessary and to reaffirm those of utility. The litigation that is sure to arise from the events leading up to the exposure of the now infamous Equity Funding Life Insurance Company scandal will surely provide an excellent opportunity for the courts to determine just what role, if any, all of the common law elements of fraud will play in a 10b-5 action.

Soon after the Equity Funding scandal broke out in late March of 1973, it became apparent that some investors received the news of the insurance fraud scheme before the general public.\(^2\) Though the channels through which this information was leaked to a few institutional investors seem clear, many important details are as yet unknown.\(^3\) Nevertheless, the multitude of questions posed by the press and legal experts\(^4\) in the wake of Equity Funding's collapse demonstrates the present confusion as to how the securities laws dealing with insider trading should respond to the general situation. These unique questions of law arise from the following skeletal factual setting, which, while based upon the Equity Funding scandal, borrows only the more salient characteristics necessary for the discussion of law.

X, the initial “tipster,” is employed by a large insurance company. The company is a picture of prosperity, reporting over six billion dollars in outstanding policies. Sometime after leaving the company, X phones Y, an insurance stock analyst for a small brokerage house. X informs Y, that non-existent, forged insurance policies were being reported on the company’s books and then sold for cash to reinsurers. Y, the “tippee,”\(^5\) naturally being skeptical of the report since such a company is so thoroughly regulated and scrutinized, makes an investigation, which fails to produce conclusive results as to the truth, falsity or substantiality of the alleged fraud. Y then informs several clients, “sub-tippees,” who are institutional investors; they, in turn, sell their substantial blocks of securities in the insurance company. The result is such an immediate and drastic drop in the stock’s price that trading is ultimately suspended. Finally, when it publicly emerges that the bogus insurance policies’ total reported value is in the millions, the insurance company filed a chapter X bankruptcy petition, leaving the uninformed shareholders with relatively worthless securities.

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5. The term “tippee” denotes one who has received inside information from another. The term was first used by Louis Loss. L. Loss, SECURITIE$ REGULATION 3561 (Supp. 1969) [hereinafter cited as Loss].

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In the landmark case of *Securities Exchange Commission v. Texas Gulf Sulphur Co.*, decided by the Second Circuit, which has long been known as the leading court in securities legislation, the court stated that Rule 10b-5 applies to anyone in possession of material inside information who uses it for his own advantage without disclosure. Nevertheless, few appear to accept this simple statement of the law which does much to answer questions of liability in the situation herein considered. Exemplary of the questions posed in the wake of the Equity Funding scandal are the following:

Is an ex-employee [such as found in this situation] subject to the rule? Are rumors or partly verified information “material,” and if they aren’t at first, when do they become so? Does the rule mean that securities analysts whose professional obligation is to their clients must instead become unpaid SEC informants whenever they pick up important unpublicized information? Does the rule apply to everyone who gets information from an analyst? Who is liable for damages, and how much?

The basis for these questions lies in the common law influence which has permeated 10b-5 litigation.

While 10b-5 was initially a codification of common law fraud adapted to securities transactions, modification became necessary to cope with the increasingly complex market conditions. The concept of common law fraud was modified to interject the obligation of disclosure into transactions beyond the initial ambit of section 10(b) of the Act. Equity Funding gives rise to the question of how far the duty to disclose may be extended and whether it may be extended under the presently used theories of fraud. Equity Funding highlights the need for what this writer calls an “unfair trade” theory of 10b-5.

**Historical Development of the Regulation of the Use of Insider Information**

Historically an action for fraud was the only remedy for a buyer or seller who was cheated in a securities transaction. This action became the underlying basis for the anti-fraud provisions of the Securities Acts. To be liable for fraud at common law, the defendant must have knowingly made a false statement of a material fact with the intent to induce the plaintiff to rely upon the statement, and the plaintiff must

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7. *Id.* at 848.
have justifiably relied upon that statement to his detriment. For a fact to be material, its existence or nonexistence must be a matter to which a reasonable person would attach importance in determining his course of action in the transaction in question.

However, the traditional definition of fraud was liberalized to include other types of dishonest dealing. It is well established now in the law of deceit that a half-truth, i.e., a true statement which itself is misleading without stating other material facts, is just as actionable as a total lie. One will be liable if there is active concealment or other conduct preventing the discovery of the truth, or if the defendant knows of some reason that this particular person will accept as true what the reasonable person would not. Also, where there is a fiduciary duty or other similar relation of trust and confidence between the parties, the fiduciary is liable for failing to come forward with material facts. Consequently, in cases of outright falsity, half-truths, and concealment involving the transfer of securities, a simple action for fraud lies. However, where there is no affirmative statement or conduct on the part of the defendant, as in the cases of total nondisclosure, the plaintiff's action depends upon the establishment of a relationship of trust from which a duty to make full disclosure is derived.

In early cases of total nondisclosure, plaintiffs were hard pressed to establish such an association absent the customary types of fiduciary relationships. Under what is today known as the "majority rule," an officer or director of a corporation owed no fiduciary duty to its shareholder, and, therefore, none to the general public. The officer or director did owe a fiduciary duty to the corporation as an entity but not to the shareholders individually. When dealing with the corporation, he was required to make full disclosure since he was exercising a corporate function; but when dealing with individual shareholders, he was not exercising a corporate function and acted as an individual. Therefore, he could deal at arm's length without any duty to make full disclosure of material facts.

Many jurisdictions, recognizing the basic unfairness of this rule, adopted what is referred to as the "minority rule," which actually is

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9. Restatement of Torts § 525 (1938); see also 2 Harper & James, The Law of Torts, ch. 7 (1956).
10. Restatement of Torts § 538(2)(a) (1938).
11. Id. § 529.
12. Id. § 550.
13. Id. § 538(2)(b).
14. Id. § 551.
15. L. Loss, Securities Regulation 1446 (Temporary Student Edition 1961);
Walker, The Duty of Disclosure by a Director Purchasing Stock from His Stockholders, 32 Yale L.J. 637 (1923).
now supported by the great weight of American authority.\textsuperscript{16} Under this rule, officers and directors are under a fiduciary duty to make full disclosure of all material facts when dealing with stockholders. Having been placed in his position of trust by the shareholders, an officer or director may not use this position nor the material facts gained therefrom against the shareholders. Furthermore, one who knowingly receives and uses such information is liable for aiding and abetting the breach of the fiduciary duty.\textsuperscript{17} At times courts explained the fiduciary’s liability in terms of a breach of an implied warranty that full disclosure was made to the shareholders.\textsuperscript{18}

Whereas these two rules focused upon the existence of a fiduciary relationship, a third rule, the Special Facts Doctrine, focused more upon the operative facts of each case in order to determine if there was a duty of disclosure.\textsuperscript{19} First articulated in \textit{Strong v. Repide}\textsuperscript{20} by the United States Supreme Court, the rationale of the rule was that it is fraudulent \textit{under the circumstances} for one with special access to special information to knowingly use it to his advantage and another’s disadvantage. In theory, this rule is not limited to directors but extends the duty of fair dealing or disclosure to anyone in a position of special knowledge. Nevertheless, despite the rule’s great potential, it has been used in a limited manner. All of the cases decided under the rule have involved a purchase from shareholders by officers or directors. “Special facts” amounted to no more than material facts. In due course, the rule for all practical purposes merged into the minority rule.\textsuperscript{21}

Though in a state of transition and by no means uniformly accepted, the common law of fraud vis-à-vis securities transactions by 1933 had developed into what might be characterized as a law of “corporate insiders’ responsibility” or “trusteeship.”\textsuperscript{22} It was drawn almost entirely from the type of fraud based upon a fiduciary’s duty of full disclosure to his “beneficiary.” This was important since other actions based on fraud required the affirmative act of making a false

\begin{itemize}
\item[16.] Loss, \textit{supra} note 5, at 1446-47; Berle, \textit{Publicity of Accounts and Directors’ Purchases of Stock}, 25 MICH. L. REV. 827 (1927).
\item[20.] 213 U.S. 419, 431 (1909).
\item[21.] Loss, \textit{supra} note 5, at 1447.
\item[22.] \textit{id.} at 1448.
\end{itemize}
statement or at least a half-truth. In order to be a matter of fact upon which one could reasonably rely, the inside information had to be used by an officer or director in a fiduciary position. In the alternative the information had to be acquired and used by one who knew that the leak of information was a breach of trust. An action could only be based upon the purchase of stock by fiduciaries or those who knew of the breach of trust since no duty was owing to non-shareholders. Furthermore, there could be no action if the purchase was executed upon an exchange since the seller would not know he was dealing with an officer or director. The Special Facts Doctrine’s emphasis upon the basic unfairness of taking advantage of those who do not have equal access to information was, however, an important step toward the type of regulation envisioned by the drafters of the 1933 and 1934 Acts.

Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated by the Securities and Exchange Commission cannot be construed solely on the basis of a close reading of their legislative and administrative history. To begin with, it is sparse and contradictory in many respects. Furthermore, the courts have moved well beyond the original basis of the statute in responding to changing times and market conditions never anticipated when the legislation was drafted in the aftermath of the 1929 crash. Nevertheless, a cursory review of the Congressional background of the 1934 Act coupled

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25. Section 10(b) provides:
   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 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.
26. Rule 10b-5 provides:
   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.
with the judicial development of Rule 10b-5 will be helpful in understanding the dilemma today’s courts face in total nondisclosure cases.

President Roosevelt characterized the Act by stating, “The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business.” To provide this protection it was Congress’ intent to substitute a philosophy of disclosure for the philosophy of caveat emptor. The House Committee which considered the bill made the following observation:

[N]o investor, no speculator, can safely buy and sell securities upon exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. Honest business was to be unimpeded since the Act’s objective was to require nothing more than the disclosure of basic facts upon which outsiders could apply their own evaluative expertise in reaching their own investment decisions.

Despite the broad egalitarian statements of policy, Congress’ immediate concern was apparently limited to the prevalent evil of the use of inside information by corporate officers for their own advantage at the expense of uninformed minority shareholders. This type of fraud was already covered by the common law fraud cause of action, yet continued to be widely practiced. Yet, it is clear that to some extent Congress intended to go beyond the existing law of fraud for the protection of all the public through an open market of equal opportunity. Furthermore, Congress was almost certainly aware of contemporary trends in the law of fraud. The common law courts and legal writers were beginning to articulate the belief that the doctrines of fraud and deceit which had developed around transactions involving land and other tangible items of wealth were ill-suited to the sale of such intangibles as advice and securities, and that, accordingly, the doctrines must be adapted to the merchandise in issue.

Just how far Congress intended to go beyond common law fraud, however, is uncertain; and the resolution of that question was left for the courts. The language of 10(b) was certainly drafted broadly

30. For a complete history of the beginnings or governmental regulation of the securities industry see Loss, supra note 5, at 23-30.
31. See, e.g., S. REP. No. 1435, 73d Cong., 2d Sess. 55 (1934).
33. See generally Shulman, Civil Liability and the Securities Act, 43 YALE L.J. 227 (1933).
Equity Funding

enough to allow the Securities and Exchange Commission and the courts flexibility to effectuate the Act's remedial purposes.\textsuperscript{34} Rule 10b-5, (adopted by the Commission) also contained broad language\textsuperscript{35} but provided the courts with a problem as to what the impact of the Rule should be upon cases of total nondisclosure.

Section (2) of Rule 10b-5\textsuperscript{36} addresses itself directly to fraudulent statements. Yet this section is clearly inapplicable to total nondisclosures and makes only false statements and half-truths illegal.\textsuperscript{37} This would indicate that if one said nothing, the normal case in transactions over an exchange,\textsuperscript{38} one would not be violating 10b-5. Yet at common law, under the fiduciary duty theory, an action for total nondisclosure existed in those limited situations where a director failed to make full disclosure to a shareholder. The courts, accepting the general policy of market egalitarianism, were able to merge this common law proscription against nondisclosure into the general fraud proscriptions of Sections (1) and (3) of 10b-5. Thus, within 10b-5 (1) and (3) the traditional common law notions of fraud were seen as one variety of the latter. This was justified as necessary to effectuate the remedial purpose of the legislation.\textsuperscript{39}

Louis Loss notes that the courts have been moving toward something like the old Special Facts Doctrine in cases of total nondisclosure.\textsuperscript{40} This is true; however, the courts have not clearly articulated that they are basing liability on the basic unfairness of using inside information. By articulating the imposition of liability in terms of an "unfair trade" theory the courts would do much in resolving the current confusion as to the scope of 10b-5. In keeping with the Act's policy of fair dealing, liability would then be imposed where one has traded securities with the benefit of publicly undisclosed information which was derived from a corporate source. Thus the basis of such liability would be the basic unfairness of using information which the public reasonably expects to be made available to everyone or no one.

\textsuperscript{34} See supra note 25.
\textsuperscript{35} See supra note 26.
\textsuperscript{36} Id.
\textsuperscript{38} One possible exception would be where an issuer had released a false or misleading statement. In such a situation, investors trading in the issuer's securities on an exchange may be defrauded through their reliance upon such statements even though the statements were not directed toward them. However, the focus herein is upon individuals who have inside information but do not usually release public statements concerning that information, i.e., cases of total nondisclosure.
\textsuperscript{40} Loss, supra note 5, at 3587 (Supp. 1969).
Instead, the courts have unfortunately used the traditional common law rubrics of the fiduciary duty theory in extending the scope of 10b-5. This in part has caused the present confusion as to its scope. Though such cases as In the Matter of Cady, Roberts and SEC v. Texas Gulf Sulphur Co. have endorsed the less restrictive basic unfairness approach, courts and legal writers are still attempting to articulate ingenious theories enabling them to characterize parties as insiders, giving rise to a fiduciary duty to make full disclosure. Just as the fiduciary theory has been twisted beyond recognition, the other elements of the traditional fraud action such as privity, materiality, and reliance have undergone a tortuous metamorphosis. And yet this distortion of the law of fraud was all done to create the same results as a modified special facts rule or more aptly an “unfair trade” theory which is easily harmonized with the remaining elements of 10(b).

THE FIDUCIARY DUTY AS THE BASIS OF THE DUTY TO MAKE FULL DISCLOSURE

The use of the fiduciary theory as the basis of a duty to disclose creates the unnecessary hurdle of finding some relationship of trust or status of the defendant which creates a duty. At common law, when two parties transacted business at arm’s length, the only duty was to refrain from making false statements of fact or half-truths. In these situations the rule of caveat emptor applied except where there was a relationship of trust. In that case one was required to come forward upon his own initiative with pertinent material facts. Since Section (2) of 10b-5 made no blanket rule imposing a duty to make full disclosure, the courts reverted to the fiduciary theory of fraud in order to hold lack of disclosure a violation of 10b-5 (1) or (3), the general fraud provisions.

The courts are quick to note that the defendant is an officer, director or control person, in order to establish a relationship of trust. The duty of disclosure to “tippees” was extended under the theory that such a defendant was aiding and abetting in the breach of the fiduciary duty. The task of finding a relationship of trust was more diffi-

42. 401 F.2d 833 (2d Cir. 1968).
cult, though, in other cases. In the courts’ search for a fiduciary status in other cases, emphasis was often placed upon the fact that the person was an employee who could also be expected to respect corporate information as if it were property. This was little more than an extension of agency law. The agent is a fiduciary of the corporation, and the corporation is owned by the shareholders. Thus the agent may be said to have a fiduciary duty toward the shareholders.

The nature of the defendant’s position has also been emphasized to support the imposition of fiduciary duties. The most well known example of this is the “shingle” theory. A broker-dealer who hangs out his shingle impliedly warrants to his customers that he will treat them fairly. Closely related, if not the same, is what is termed the “policing function theory.” This concept is derived from the fact that a brokerage firm may be a member of the New York Stock Exchange or NASD. Such membership gives rise to a duty to make certain that its corporate information is made public. This duty is policed by the respective organizations. The size, relationship and proximity to the public of the defendant have also been considered factors upon which a fiduciary duty may rest.

Courts seemingly feel more at ease with cases of true deception where there are false statements made or half-truths stated than with cases of total nondisclosure. This may explain their tendency to favor an implied warranty theory in cases of total nondisclosure. Implied warranty theories are primarily used where some fashion of a fiduciary position is found but it does not extend technically to the plaintiff. It could be reasoned that the statute itself extends the director’s common law duty to the shareholders to encompass the general public, but this has not been done. Rather the fiduciary theory itself had undergone some curious twists in order to extend the director’s duty. Judge Learned Hand, in *Gratz v. Claughton*, reasoned that the director or officer who sold to one not already a shareholder and therefore

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46. See Loss, supra note 5, at 1490.
50. Such a situation exists where the defendant is an officer or director, but the plaintiff who bought shares of the officer’s or director’s company is not a beneficiary of his position of trust until after the sale.
not already a beneficiary of the director's trust assumes a fiduciary relation to that person "by the very sale" to him. He considered this especially true when the buyer does not know of the seller's status, as in sales over an exchange. In such a situation the seller was said to be "entitled to assume that if his seller in fact is already a director or officer, he will remain so after the sale."\textsuperscript{52}

However, many courts adopted the implied warranty theory, rejecting Judge Hand's reasoning. Under the implied warranty theory, the director can be held to have made a false statement of fact by finding that he made an implied warranty that his corporation's stock is worth the price asked. An excellent example of a court relying upon this theory to support a violation of 10b-5 is *Speed v. Transamerica Corporation*.\textsuperscript{53} The court stated that the three sections of 10b-5 are "mutually supporting and not mutually exclusive," and therefore, an insider's breach of his disclosure obligation "can be viewed as a violation of all three subparagraphs."\textsuperscript{54} The court used the traditional theory to establish the duty of disclosure, even though it might have gone farther and taken an "unfair trade" approach. In this case the defendant, a director, in making an offer above the current market price, had impliedly represented that the price offered was a fair price at that time.\textsuperscript{55}

While so much attention is given to the person's status with respect to other traders and his resulting duty to disclose private material facts where he uses them to trade for his own benefit, it is obvious that the real reason liability is imposed is not based upon any relationship between the parties since, all too often, it is no more than a legal fiction. Rather, liability is imposed because it is patently unfair to take advantage of one who cannot protect himself against another who has inside information. Even if one using the information is not technically an insider, the rule should not be applied any differently. Whether one comes across information by way of private negotiations with the corporation or through a friend who is an insider is of little consequence. This is especially so in light of the now accepted policy of the Act to provide equal market opportunity.\textsuperscript{56} The true basis of a 10b-5 action is that information which is private or not generally known and which is used to the detriment of the public gives rise to liability.

\textsuperscript{52} Id. at 49.
\textsuperscript{54} 99 F. Supp. at 829.
\textsuperscript{55} Id.
Beyond the failure to recognize the true nature of the duty to make disclosure under Rule 10b-5, the use of the fiduciary theory and its ancillary implied warranty theory unduly restricts the Rule's application while doing a disservice to the reasoned application of principled law. In cases in which the plaintiff buys into the company from an officer or director, it places the proverbial cart before the horse to say the director owes the plaintiff a fiduciary duty of disclosure because after the sale the buyer will become a beneficiary of the director's trust.

The use of a fiduciary relationship as the basis of the duty to disclose also creates the wrong impression of the nature of 10b-5's prohibition of misuse of inside information. This is so when the defendant is a true fiduciary as is an investment adviser with respect to his clients. Here it can be argued that the duty of disclosure to investors at large under 10b-5 may be balanced against the fiduciary's duties to his clients. Since he is directly dealing with his clients and only remotely with the public, the former "beneficiaries" are owed a greater duty of fair dealing. Rejecting the distortions inherent in the fiduciary theory of 10b-5 liability and substituting a rational, extensive, broad-based duty of fair dealing enforces the obligations 10b-5 should impose on all as a matter of law. This is the response Commissioner Cary made to just such an argument by the defendant broker-dealer in Cady, Roberts.57 There, an agent of the brokerage firm received inside corporate information from the firm's registered representative who was also a director of the corporation. The broker executed several transactions over an exchange on behalf of discretionary accounts. He pointed out that the broker-dealer's higher duty was to the law and that clients could not reasonably expect their broker-dealer's obligation to them to include breaking the law.58

The implied warranty theory fares no better. Under this theory, the purchaser is said to reasonably expect the director to make disclosures. However, the court in the Transamerica Corp. case59 made it clear that this duty arose since a director has a fiduciary duty to the shareholders. The purchaser who would soon be a shareholder could reasonably entertain such expectations.60 This, then, is nothing more than Judge Learned Hand's twisted justification for extending a director's fiduciary duty to the entire public.61

58. Id. at 916.
59. See discussion supra at 252.
60. 99 F. Supp. at 829.
61. See discussion supra at 251-52.
Arguably, the courts could dispense with the tattered common law theories and rely instead simply upon the broad language of the Rule, the Act and its remedial policy which is antagonistic to unfair dealing in securities. The realization that doctrines of fraud are adaptable to securities parallels the developments in other fields of the law which have rejected the concept of *caveat emptor* to varying degrees. When dealing with matters over which certain persons have extensive control while others have neither control nor the ability to protect themselves from the overreaching practices of those in control, such changes have occurred. Truth-in-Lending, products liability and consumer advertising are examples of the areas of law that have experienced this change in approach. In securities law, under an “unfair trade” approach, *caveat emptor* is still viable, but only to the extent that buyers and sellers are on equal footing as to knowledge of the material facts. Such investors must still be aware that others may have better expertise in utilizing those facts.

Actually the first steps toward grounding Rule 10b-5 liability upon an “unfair trade” basis may be found in several cases. Unfortunately, their approach has not as yet been fully accepted. Nevertheless, the cases manifest an increasing awareness that it is simply the possession of undisclosed material information which produces the obligation to make disclosure before entering the market regardless of the possessor’s status or relation to those injured.

The first major step in this direction was taken in an SEC administrative proceeding, *In the Matter of Cady, Roberts*.\(^6\) *Cady, Roberts* was the first time violation of 10b-5 was found in a case involving total nondisclosure of material inside information in a transaction executed through an exchange. The sales involved were of Curtiss-Wright stock by a brokerage firm following that corporation’s decision to reduce its dividend. While the planned reduction had not been publicly announced, the firm had been notified of the dividend cut by its registered representative, who was also a Curtiss-Wright director. The firm in turn executed the sale of the corporation’s stock for several clients’ discretionary accounts.

Commissioner Cary stated that the obligation imposed by 10b-5 rested 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 ad-

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vantage of such information knowing it is unavailable to those with whom he is dealing.63

He went on to note that 10b-5 should not be narrowly applied and that the obligation, though imposed primarily upon insiders, extends potentially to “any person.”64 In other words, if the information could be traced along a line running to the corporation and not to some external source, the knowing possessor of the information would not be entitled to use it without disclosure. Manifestly, then, it was the source and nature of the information, not the possessor’s status, that was dispositive since inside lines to information must be open to everyone or no one under the 1934 Act.

Seven years later, the broad approach of Commissioner Cary finally attained judicial recognition in SEC v. Texas Gulf Sulphur Co.65 However, in both Cady, Roberts and Texas Gulf Sulphur, officers and key employees were involved in information leaks and insider trading. Consequently, except for the fact that an exchange was used to execute the sales, each case involved parties who, under the fiduciary theory, could have been held to have a duty to disclose. Also neither case involved the liability of “tippees” who could not be characterized as fiduciaries.

The 1971 case of Financial Industrial Fund, Inc. v. McDonnell Douglass Corp.,66 though, is closer to the situation herein considered. In this administrative proceeding, Merrill Lynch was acting as underwriter for a McDonnell Douglass securities distribution. Merrill Lynch was found to have leaked the news of a drastic decline in McDonnell Douglass earnings to several mutual funds, producing a rash of selling that brought the stock’s value crashing down. Not surprisingly, Merrill Lynch was held liable for giving the tip despite its obligation to the mutual funds as clients. The Commission imposed liability on Merrill Lynch, focusing upon its status as a large company in close proximity to the public, thereby returning to the fiduciary theory of liability.67 However, in a highly unusual move, the Securities and Exchange Commission decided that these mutual funds were also guilty of a violation of Rule 10b-5, in a separate proceeding, though

63. Id. at 912.
64. Id. at 913.
an administrative penalty rather than civil liability was at issue.\textsuperscript{68}

In \textit{Texas Gulf Sulphur}, the court indicated that it did not matter whether 10b-5 liability was predicated on the traditional fiduciary theory or upon the Special Facts Doctrine (which as noted above is closer to an "unfair trade" theory), since the Rule was based upon principles of equal access to market information.\textsuperscript{69} The court went on to state that the "rule is also applicable to one possessing the information who may not be strictly termed an 'insider.'"\textsuperscript{70} Yet the Commission itself, usually favoring the Rule's broadest application, hesitated in finding Merrill Lynch liable in \textit{McDonnell Douglass} and did so only by finding Merrill Lynch to be in a position of public trust. From this it is clear that as defendants become less susceptible to categorization as fiduciaries, the Commission and the courts will less likely impose liability as mandated by the Rule and Act under the principle of equal access to market information.

Consequently, it makes a difference whether the liability under 10b-5 is based upon the traditional fiduciary theory or under an "unfair trade" theory, applicable to all who would take advantage of the unprotected investing public. Consider the Equity Funding situation. The investment adviser who is tipped off by one who is not clearly an insider is even less likely to be viewed as an insider, and thus less likely to be held liable under the traditional theory. This would be so even where the investment adviser uses the information or allows his clients to do so, knowing that the public will suffer losses which he or his clients have avoided by the secret information. In contrast, under the Act's clear policy, this information belongs to everyone or no one; consequently, nondisclosure is \textit{patently unfair}. This is the true basis of 10b-5 liability.

\textbf{COLLATERAL CONSEQUENCES OF THE "UNFAIR TRADE" APPROACH}

Even if it were established that the defendant either made a false statement of fact or had a duty to disclose and did not, the plaintiff at common law still had to prove the other elements of his cause of action.\textsuperscript{71} Traditionally it was necessary for the plaintiff to show that the defendant's conduct caused the injury to the plaintiff, for only then could the defendant be deemed at fault. But to prove causa-

\textsuperscript{69} 401 F.2d at 848.
\textsuperscript{70} Id.
\textsuperscript{71} See discussion of common law action \textit{supra} at 244-47.
tion, the plaintiff had to prove two related elements: that the facts in question were material, and that he reasonably relied upon these facts. Furthermore, in early 10b-5 cases, the plaintiff and defendant dealt with one another face to face, one purchasing from the other. In this respect, then, there was always the element of privity between the parties. Rule 10b-5 case law, though, has been evolving in respect to all of these elements. In moving away from the 1934 Act's common law moorings, important questions have arisen bearing directly upon an Equity Funding situation.

The elements of causation, reliance and materiality, though conceptually distinct, are inextricably related. In *List v. Fashion Park*, the court distinguished materiality and reliance in this manner: the former involved the objective question of whether a reasonable person would have been influenced to act differently, while the latter involved the subjective question of whether this particular plaintiff would have acted differently. Each by itself, then, is but one facet of causation. Materiality focuses upon whether the plaintiff's own unreasonableness was the more proximate cause, whereas reliance focuses upon whether there was causation in fact. Though distinct in this respect, their interrelation is obvious. There can be no justifiable reliance in absence of a material fact. As a corollary, there can be no finding of causation in fact in the absence of justifiable reliance.

While these elements may be viewed as merely facets of causation, causation may be viewed as an element in itself. For example, the defendant may have issued a false statement causing the market to indicate a spurious price. Other market conditions, however, may have contemporaneously added to the spurious nature of the market price. In this situation the defendant cannot be said to have caused the plaintiff's entire loss except in the "but for" sense, *i.e.*, the plaintiff would not have incurred any loss (including that portion attributable to external market conditions) but for the fact that the defendant's fraudulent acts induced him to buy or sell. The courts do not very often make it clear whether they are referring to causation vis-à-vis damages or causation vis-à-vis injury.

The role to be played by the relationship between privity and reliance in 10b-5 litigation is also evolving. As probative hurdles to be overcome by the plaintiff, they have traditionally served to limit instances of lia-

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72. The discussion of materiality is limited here only to the extent necessary for the discussion of the elements of causation, reliance and privity.
74. *Id.* at 462.
bility. More importantly, these 10b-5 elements have served to limit liability to certain types of schemes to defraud.\textsuperscript{75} The common law, though, in respect to these elements, has not fostered the restrictiveness produced by a narrow reading of the Act. In fact, privity was never required at common law,\textsuperscript{76} and the common law itself has liberally evolved in respect to reliance.\textsuperscript{77} This may explain the willingness to change 10b-5 case law in these respects, eliminating the privity requirement\textsuperscript{78} and liberalizing the reliance requirement.\textsuperscript{79}

With the demise of the privity requirement, it is not surprising that a rethinking of the reliance element of the 10b-5 cause of action would have been necessary. In a traditional face-to-face situation, the defendant could clearly be seen to have relied upon the defendant's false statement which therefore caused his injury. However, when the plaintiff is removed from the defendant, such as in cases involving the use of an exchange, the question of reliance becomes more difficult. The SEC has taken the position that the "reliance" requirement should be confined to situations where the transaction is personally negotiated and should not be applied to defeat recovery for routine transactions on an exchange or over the counter.\textsuperscript{80} The common law itself has adjusted to cases in which the plaintiff and defendant never dealt face-to-face with one another.

That 10b-5 law has incorporated the same liberalization of the reliance requirement as has the law of fraud seems clear. In rejecting the privity requirement in \textit{Heitz v. Weitzen},\textsuperscript{81} the Second Circuit reasoned that though the defendants intended to defraud the United States and not the investors, they could be held liable for injuries to investors since the investors could have reasonably anticipated that they would rely upon the statements made to defraud the government.\textsuperscript{82}

\textsuperscript{75} E.g., privity and reliance would, if taken in their strict traditional sense, limit actions to face-to-face transactions of false statements and half-truths, and no action would lie where the sale was transacted on an exchange, especially for cases involving total nondisclosure.

\textsuperscript{76} See Joseph v. Farnsworth Radio & Television Corp., 198 F.2d 883, 884 (2d Cir. 1952) (Frank, J., dissenting).


\textsuperscript{81} 402 F.2d 909 (2d Cir. 1968).

\textsuperscript{82} \textit{id.} at 913.
In such cases of total nondisclosure, the question of reliance has been posed as a hypothetical, *i.e.*, would the plaintiff have acted differently if he had known the facts which the defendant withheld from him.\textsuperscript{83} Since the question is posed in this manner, it appears to be the trend for the courts to assume reliance once materiality is shown.\textsuperscript{84} One can only speculate as to what a particular plaintiff would have done had he known all material facts; therefore, the courts can only presume the plaintiff would have acted reasonably. Consequently, when materiality is established by showing that reasonable persons would be influenced by the undisclosed facts, reliance is also established since the plaintiff is presumed to be reasonable. Apparently, it remains as a defense for the defendant to demonstrate that the plaintiff would have acted the same had he known the undisclosed facts. Were it otherwise, the plaintiff would be faced with the almost insurmountable burden of proving that he would have acted differently, effectively barring most actions for total nondisclosure.

The end result of posing the question of reliance in this hypothetical manner has been to make the elements of reliance and causation interchangeable.\textsuperscript{85} Thus, the sole question to be answered in total nondisclosure cases is whether a reasonable person would be influenced by the facts had they been known. If the answer is affirmative, then the defendant's failure to disclose the facts constitutes the cause of the plaintiff's injury.

The demise of the privity requirement and the courts' tendency to dispense with the reliance requirement have greatly broadened the effectiveness of 10b-5. No longer bound by these restrictive elements, investors who are remote, yet causally connected to those who would defraud them, may now maintain a 10b-5 action for relief. Such defendants, whose aggregate sales of stocks might be only a small portion of the day's total volume, could theoretically be liable to all those who

\textsuperscript{83} Rogen v. Ilikon Corp., 361 F.2d 260, 266 (1st Cir. 1966); List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.), \textit{cert. denied}, 382 U.S. 811 (1965); Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963).

\textsuperscript{84} Indeed it may be that the courts are moving beyond an assumption of reliance in total nondisclosure cases. In Green v. Wolf Corp., 406 F.2d 291 (2d Cir. 1968), the Second Circuit rejected the argument that a class action cannot be maintained since reliance cannot be proven, though the court expressed no views on the issue of the necessity of showing reliance. In Financial Industrial Fund, Inc. v. McDonnell Douglas Corp., CCH \textit{Fed. Sec. L. Rep.} ¶ 93,004 (D.C. Colo. 1971), the district court noted that the statute requires the conduct only be "in connection with a purchase or sale" and makes no requirement of reliance. The court went on to note that "the open market situation does not preclude the presence of reliance. The court must, however, be guarded in reaching a conclusion that the essential connection has been satisfied." \textit{Id.} at 90,702.

purchased on that same day. Broadening the scope of 10b-5 may be viewed as the opening of a "Pandora's box" in respect to the potential liability in nondisclosure cases. Should the courts' liberal position be taken to its logical conclusion, defendants will face relatively unlimited liability.

Though the strong deterrent effect of such unlimited liability would indeed be significant, no court has yet recognized such extensive liability. Despite the theoretical and policy bases for imposing such liability, unlimited liability is rather strict and very possibly too severe. A court could quite reasonably hesitate to impose such far-reaching liability in light of the causal uncertainties that are involved with respect to both the injury per se and the resulting damages.

It is uncertain whether the change in market price after disclosure indicates the true amount of damages. The market may very well have overreacted, or the drop may, in part, be attributable to external market factors. Though these external market influences may be proportionately small in comparison to the influence of the then disclosed facts, the monetary loss caused by external market forces may be considerable. The uncertainties of causation of injury per se, or rather reliance, also add to the injustice of making the defendant liable on the "but for" basis used in total nondisclosure cases. In fact, many plaintiffs might have acted the same, even with disclosure. People do act unreasonably, and many more invest without making inquiry due to either occasional carelessness or outright stupidity. In these respects, such extensive liability would make the defendant an insurer for all losses that would not have occurred but for his conduct, a result contrary to traditional damage theory which is based upon fault. That such losses are foreseeable does little to ameliorate the unfairness of the measure of damages.

The magnitude of the unresolved question of limitless liability demands a definitive response. This is especially true in the regulation of a national market system where uniformity is essential. It is true that in some instances the problem may not arise. The costs and risks of litigation may often reduce the number of plaintiffs. Causation may be disproved by the defendant. It should be noted, how-

87. The term "injury per se" refers to a loss which would not have occurred but for the defendant's conduct, as distinguished from resulting damages which may not be completely attributable to the defendant's conduct, e.g., losses due to a concurrent market slump.
ever, that this may be a difficult task where there are multiple plaintiffs. Yet where the problem is unavoidable, it will not do for the courts to take an ambiguous stance. Very possibly, no one rule would prove adequate; but some standard for future guidance is necessary. That standard may well be found in the ghost of the privity requirement.

It is now well established and supported by both theory and policy that privity should not be a mandatory condition of 10b-5 action. Several courts, though, have suggested that privity should at least have a bearing upon the cause of action. While the very narrow relationship of privity is not required, the fraud must be perpetrated "in connection with a purchase or sale," so that some relationship is necessary, albeit a loose one. In Financial Industrial Fund, Inc. v. McDonnell Douglas Corp., the court stated,

"The court must, however, be guarded in reaching a conclusion that the essential connection has been satisfied. . . . It calls rather for a general inquiry as to whether there was both a factual and legal connection." The court went on to suggest that the substantial factor test may prove to be an adequate method of determining if the essential connection exists. Under the substantial factor test, it must appear that the defendant's conduct constitutes a material (i.e., substantial) element in creating the loss. Facts which negate the "but for" test of causation, such as external market considerations or the fact that a plaintiff may have been disposed to buy or sell the security in question in any event, are taken into consideration. Unlimited liability will not be imposed as a matter of course. In essence, the consideration of these negating factors operates as a surrogate for the discarded privity requirement.

CONCLUSION

It is clear that the time for reappraising the influence that common law concepts of fraud should have in 10b-5 actions has come. The uncertainty in the law as demonstrated by the confused reaction to the Equity Funding situation fully demonstrates this. Litigating the possible liability of those involved in this situation will provide the courts with an opportunity to make this reappraisal.

90. CCH FED. SEC. L. REP. ¶ 93,004 at 90,702.
91. Id.
The Equity Funding situation will test the courts' willingness to further stretch and twist the common law fiduciary basis of the duty to disclose. It is this basis upon which the courts have predicated liability in similar cases of total nondisclosure. Yet the Equity Funding situation poses problems since information was leaked by one who was no longer an officer and who could no longer be held accountable to protect the corporation's market position. The first "tippee" was a member of a smaller brokerage firm. Thus the "tippee" was less susceptible to being labeled as a holder of the public's trust, as was Merrill Lynch in the McDonnell Douglas case. Unless the courts acknowledge the true basis of the duty to disclose, i.e., that under current standards, investment information is to be equally shared, the policy of the securities legislation to protect the general public from the overreaching of a few may not be realized in many cases. Even if this goal is realized, to do so by further distortion of the common law theories can only work to the ultimate detriment of a rational, principled scheme of securities regulation.

The courts have already done much to dispense with the elements of privity and reliance in similar cases of total nondisclosure, thereby drawing 10b-5 liability further away from its common law origin. Whereas an unfair trade basis clearly appears as a viable alternative to establishing a duty to disclose, there is no one approach clearly available for setting the limits of liability as the elements of privity, reliance and materiality had done. Without these common law elements which too narrowly have limited the scope of one's liability, defendants now face the relatively unlimited scope of liability which could serve to impose windfall recoveries.

The Equity Funding situation will provide the courts with the opportunity of resolving this possibility of relatively unlimited liability. Having rejected the rigid and too restrictive rules of privity and reliance, the courts should take care to avoid going too far in relaxing the standard of liability. By adopting the traditional substantial factor test, the courts will do much to provide a suitable limitation. Having been well defined over the years, it will prove workable for courts already familiar with the concept.

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