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## Rule 10b-5: Birth of the Concept of Market Insider and Its Application in a Criminal Case - United States v. Chiarella

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# RULE 10b-5: BIRTH OF THE CONCEPT OF MARKET INSIDER AND ITS APPLICATION IN A CRIMINAL CASE—*UNITED STATES v. CHIARELLA*

## I. Introduction

Rule 10b-5 requires a corporate insider to disclose nonpublic market information that affects the value of the corporation's securities or abstain from trading those securities.<sup>1</sup> Courts have hitherto limited the scope of a corporate insider to those with a special relationship to the issuing corporation, principally officers and directors.<sup>2</sup> In *United States v. Chiarella*,<sup>3</sup> the Second Circuit Court of Appeals held that any person inside the market who regularly receives special knowledge of nonpublic market information has a duty to disclose that information or abstain from trading in the corporation's

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1. Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (1979). The rule 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 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 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

(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.

The rule was promulgated by the Securities and Exchange Commission under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976). This section 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 of any national securities exchange— . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on the 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.

2. See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 847-57 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). The duty to disclose or abstain has also been applied to other persons. See, e.g., *Speed v. Transamerica Corp.*, 99 F.Supp. 808, 828-29 (D. Del. 1951) (controlling shareholders); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 495 F.2d 228, 235-36 (2d Cir. 1974) (broker dealers and underwriters); *Schein v. Chasen*, 478 F.2d 817, 823 (2d Cir. 1973), vacated on other grounds sub nom. *Lehman Bros. v. Schein*, 416 U.S. 386 (1974) (tippee of a tippee of a corporate insider).

3. 588 F.2d 1358 (2d Cir. 1978), cert. granted, 99 S.Ct. 2158 (May 15, 1979) (No. 78-1202).

securities.<sup>4</sup> The court reasoned that only with such a rule could the purpose of protecting the public securities markets be achieved.<sup>5</sup> The district court's judgment and the court of appeal's affirmance of a criminal conviction raises an unsettling problem of due process.<sup>6</sup> Serious doubt exists whether Chiarella had fair notice that his conduct constituted criminal liability. This Note will argue that whereas the concept of market insider expressed in *Chiarella* is a proper expansion of the scope of rule 10b-5, the conviction of the defendant is an unconstitutional retroactive application of a criminal sanction.

## II. *United States v. Chiarella*; Facts

While employed as a "markup man" at Pandick Press,<sup>7</sup> Vincent Chiarella used information which he obtained during the course of employment to make several profitable securities transactions. Between September 1975 and November 1976 Chiarella had access to confidential documents that outlined plans for five different takeover bids of different target corporations. Although the names of the offeror and target corporations were disguised by the use of secret code names in the documents, Chiarella, an experienced market trader, managed to break the code.<sup>8</sup> Chiarella purchased the stock of the target corporations before the tender offers were disseminated to the target shareholders and was thereby able to profit from the subsequent rise in the price of the stock resulting

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4. *Id.* at 1365.

5. *Id.*

6. See notes 63-95 *infra* and accompanying text.

7. Mr. Chiarella worked for Pandick Press, an independent firm located in the financial district of Manhattan which specialized in printing disclosure statements, newspaper announcements, and offering and transmittal letters for security transactions, mergers and tender offers. As a "markup man" the defendant was the first person to receive copy when it arrived at Pandick; he would then select the type fonts and layouts and would then send the material to be set in type. 588 F.2d at 1363.

8. Chiarella could deduce the identity of the target corporations by considering the number of letters in the code names, par values of the stock, and price histories. In one instance the defendant deduced from information in the documents that the names "Arabia Corp." and "USA Corp." were in fact code names for Emhart Corp. and USM Corp. respectively. The identity of the number of letters in the code names with those in the actual names was necessary because the code names were replaced with the actual names moments before the material was printed. The use of the code names preserved the secrecy of the corporate identities and aided printing efficiency. Such secrecy is important in any takeover bid to avoid speculation and rising prices of the target stock. *Id.*

from the tender offer. After fourteen months and seventeen transactions Chiarella had realized a profit of over \$30,000.<sup>9</sup> In May 1977 an investigation was conducted by the Securities and Exchange Commission which resulted in an enforcement proceeding against Chiarella.<sup>10</sup> In this proceeding Chiarella entered into a consent decree<sup>11</sup> whereby he agreed to disgorge his profits to the shareholders of the target corporations. On January 4, 1978 a federal grand jury indicted the defendant on seventeen counts of willful misuse of material<sup>12</sup> nonpublic information in connection with the security transactions. The indictment alleged that the purchases and sales of securities by Chiarella violated section 10b of the Securities Exchange Act of 1934 and rule 10b-5. Chiarella was convicted by a jury on every count.<sup>13</sup> On appeal the Second Circuit Court of Appeals affirmed the conviction.<sup>14</sup>

### III. The Development of Market Insider Liability

At common law one had a duty to disclose material information only where a fiduciary relationship was shown to exist between the purchaser and seller of the securities at issue.<sup>15</sup> In *Strong v. Repide*<sup>16</sup>

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9. *Id.*

10. SEC v. Chiarella, No. 77 Civ. 2534 (S.D.N.Y. May 24, 1977).

11. A consent decree is a device frequently employed by the SEC whereby a party neither admits nor denies guilt but agrees to a disposition in order to avoid going to trial. A consent decree may resolve questions of fact and law as between the parties, but the judgment entered on the consent of the parties "has no greater dignity . . . than any judgment entered only as a compromise of the parties." *United States v. International Building Co.*, 345 U.S. 502, 506 (1953).

12. An essential element under rule 10b-5 is that the information be material. *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir.), *cert. denied*, 382 U.S. 811, *reh. denied sub nom. List v. Lerner*, 382 U.S. 933 (1965). When a reasonable investor would consider the information important in determining whether to buy or sell the security then the information is deemed material. *See SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969). In *Chiarella* the information was stipulated as being material. 588 F.2d at 1364 n.5.

13. Chiarella moved to dismiss the indictment for failure to state a crime, however his motion was denied. Judge Owen's opinion denying the motion is reported at 450 F. Supp. 95 (S.D.N.Y. 1978). Judge Owen sentenced the defendant to concurrent terms of one year for each of the first thirteen counts. However, the sentence shall be automatically suspended after one month imprisonment; a five year term of probation is to follow. 588 F.2d at 1364 n.7.

14. The majority opinion was written by Chief Judge Kaufman and joined by Judge Smith. The dissenting opinion was written by Judge Meskill.

15. *See, e.g., Strong v. Repide*, 213 U.S. 419, 430-31 (1909). *See also* 3 L. LOSS, SECURITIES REGULATION 1446-48 (2d ed. 1961).

16. 213 U.S. 419 (1909).

the Supreme Court held that a fiduciary relationship existed when a corporate director purchased shares of the corporation without disclosing his identity and special knowledge to the selling shareholders.<sup>17</sup> The general common law majority rule, as noted by the Court, was that "the ordinary relations between directors and shareholders in a business corporation are not of such a fiduciary nature as to make it the duty of a director to disclose the general knowledge which he may possess regarding the value of the shares before trading."<sup>18</sup> While the Court found the defendant guilty it expressly stated that the holding was limited to the "special facts" and circumstances of the case.<sup>19</sup> Notwithstanding the Supreme Court's attempt to limit the holding of the case, *Strong* was used as precedent in later cases which held that officers and directors of corporations as fiduciaries have a duty to disclose nonpublic material information before purchasing shares of the corporation.<sup>20</sup>

With the enactment of the Securities Exchange Act of 1934 the duty to disclose material information was imposed on all corporate insiders. Rule 10b-5, promulgated pursuant to the Securities Exchange Act of 1934, prohibits various types of fraud including misrepresentations and omissions in statements describing corporate activities, mismanagement, manipulation of the market, tipping, and fraud in connection with the exchange of securities.<sup>21</sup> Included in this last category is insider trading on nonpublic information without first disclosing the information to the general public. In *SEC v. Texas Gulf Sulphur Co.*,<sup>22</sup> the Second Circuit held that officers and directors of a corporation must disclose material information affecting the value of the securities or abstain from trading

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17. *Id.* at 430-31.

18. *Id.* at 431.

19. *Id.*

20. 3 L. LOSS, SECURITIES REGULATION 1446-48. See, e.g., *Strong v. Repide*, 213 U.S. 419 (1909); *Schein v. Chasen*, 478 F.2d 817, 823 (2d Cir. 1973), *vacated on other grounds sub nom. Lehman Bros. v. Schein*, 416 U.S. 386 (1974); *Frigitemp Corp. v. Financial Dynamics, Inc.*, 524 F.2d 275, 282 (2d Cir. 1975); *Kohler v. Kohler Co.*, 319 F.2d 634, 652 (7th Cir. 1963); *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 828-29 (D. Del. 1951); *Diamond v. Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969); *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

21. 5 A. JACOBS, THE IMPACT OF RULE 10b-5 §1 (1978).

22. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

the securities.<sup>23</sup> In this decision the court emphasized that the duty to disclose was not limited to those in a fiduciary relationship with the issuing corporation.<sup>24</sup> The court stated that "anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."<sup>25</sup>

This concept adopted the SEC position previously enunciated in *Matter of Cady, Roberts & Co.*<sup>26</sup> In this case the Commission held that a corporate insider or a tippee of a corporate insider had a duty to disclose.<sup>27</sup> This duty to disclose did not emanate from the fiduciary duty which corporate insiders owed to shareholders,<sup>28</sup> but rather, from "the existence of a special relationship giving access . . . to information intended to be available only for a corporate purpose . . . and the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. . . ."<sup>29</sup> In sum, the parameters of the duty are defined by the unfairness or unevenness in buying position.

Chiarella argued that the disclose or abstain rule was limited to those in a fiduciary relationship to the issuer,<sup>30</sup> notwithstanding the broad language in *Cady, Roberts* and *Texas Gulf Sulphur* set forth above.<sup>31</sup> The court rejected the defendant's contention that *General Time Corp. v. Talley Industries, Inc.*<sup>32</sup> compelled a different conclusion.<sup>33</sup> The *General Time* case involved an attempt by Talley

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23. *Id.* at 848.

24. *Id.*

25. *Id.*

26. 40 S.E.C. 907 (1961).

27. *Id.* at 912.

28. The Commission in *Cady, Roberts* proclaimed that the operation of rule 10b-5 would not be limited by the common law requirement of a fiduciary relationship. The Commission stated that the provisions of rule 10b-5 "are broad remedial provisions aimed at reaching misleading or deceptive activities, whether or not they are precisely and technically sufficient to sustain a common law action for fraud and deceit." *Id.* at 910.

29. *Id.* at 912.

30. 588 F.2d at 1367.

31. See notes 22-29 *supra* and accompanying text.

32. 403 F.2d 159 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969).

33. 588 F.2d at 1367-68.

Industries to displace the management of General Time in a shareholders' election of directors. Plaintiff corporation alleged that the defendant violated the disclosure provisions of the proxy rules in their proxy solicitation<sup>34</sup> and had violated rule 10b-5 because the defendants had purchased stock of the plaintiff corporation without disclosing to the sellers of the stock the plan to take over the corporation.<sup>35</sup> The Second Circuit held that a company acquiring less than five percent of the stock of another corporation is not required to disclose its potential plans for a merger.<sup>36</sup> The court stated, "We know of no rule of law, applicable at the time, that a purchaser of stock, who was not an 'insider' and had no fiduciary relation to a prospective seller, had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale."<sup>37</sup>

The defendant in *Chiarella* argued that he was in the same position as the tender offerors from whom he derived his inside information,<sup>38</sup> and therefore had no duty to disclose his information before trading. The Second Circuit rejected this argument and distinguished the defendant from the tender offerors.<sup>39</sup> As the majority opinion explained, a tender offeror, unlike the defendant, does not regularly receive non public information concerning any stock but its own.<sup>40</sup> Additionally, the bidder does not receive information but creates it.<sup>41</sup> This distinction has been criticized as inconsistent with the court's concern for equalizing access to market information.<sup>42</sup> This criticism, however, is based on the assumption that the *ratio*

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34. 403 F.2d at 162.

35. *Id.* at 164.

36. *Id.*

37. *Id.* The defendant and the dissent in *Chiarella* placed too much emphasis on the quoted language from Judge Friendly's opinion in *General Time*. The cases can be distinguished on their facts. See notes 40-43 *infra* and accompanying text.

38. 588 F.2d at 1366.

39. 588 F.2d at 1368 n.15. One authority notes that the distinction should not be based on the risk involved in the transaction, but on "the fact that tender offerors are engaged in activity roughly analogous to that of security analysts; they also investigate corporations on the basis of publicly available information in order to determine whether a stock is undervalued and represents a sound investment." Case Comment, 92 HARV. L. REV. 1538, 1545 (1979). While such activity should be encouraged, the opposite is true for persons who derive their information from non-public sources. *Id.* at 1547.

40. 588 F.2d at 1366.

41. *Id.*

42. See, Brodsky, *Trading on Non-Public Market Information*, N.Y.L.J., June 21, 1979, at 2, col. 1.

*decidendi* of *Chiarella* is to equalize market knowledge. The purpose of market insider liability, however, is to equalize access to market information, not to equalize the amount of information held by every trader.<sup>43</sup> If the opposite were true all incentives of the diligent trader would be destroyed since one would have to disclose all information before trading.<sup>44</sup>

The market insider concept, as set out in the majority opinion of *Chiarella*, is an all-inclusive rule: "Anyone—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose. And if he cannot disclose he must abstain from buying or selling."<sup>45</sup> *Chiarella* extends the "disclose or abstain" rule established by *Texas Gulf Sulphur* to apply to "anybody," not only to corporate insiders. Regular receipt of nonpublic material market information is now the sole criterion for imposing criminal or civil liability for one who deals with the advantage of inside information. In effect, the Second Circuit rejected a strict reading of *Texas Gulf Sulphur* and *Cady, Roberts* which suggested, under the facts of those cases, that liability required a "special relationship" to the issuing corporation.<sup>46</sup>

In *Chiarella* the issuing corporations were target corporations to

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43. See Fleischer, Mundheim & Murphy, *An Initial Inquiry Into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 816 (1973).

44. For a discussion of the effects of market insider liability on securities trading see Case Comment, 92 HARV. L. REV. 1538, 1545-49 (1979).

45. 588 F.2d at 1365.

46. In the same year as *General Time* the Second Circuit decided *SEC v. Great Am. Indus., Inc.*, 407 F.2d 453 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 920 (1969). The court indicated in three separate opinions that the duty to disclose imposed by judicial interpretations of rule 10b-5 would extend "beyond the area encompassed by traditional notions of fiduciary responsibility." Fleischer, Mundheim & Murphy, *supra* note 43, at 805. The defendants were sellers of mining property which was exchanged for shares of Great American stock. The alleged nondisclosure arose when the sellers failed to tell the buyer that the price paid for the property included finder's fees. 407 F.2d at 458-59. In *Great American* the court did not reach the conclusion whether or not the seller had a duty to disclose since their silence alone constituted fraud against the buyer. *Id.* at 460-61. Judge Friendly's opinion stated that "to read Rule 10b-5 as placing an affirmative duty of disclosure on persons who in contrast to 'insiders' or broker-dealers did not occupy a special relationship to a seller or buyer of securities, would be occupying new ground and would require most careful consideration." *Id.* at 460. Judge Kaufman, in a concurring opinion, went further than the majority. He stated that "those who buy or sell securities may no longer assume that the unmened fences of common law fraud will remain the outer limits of liability under Rule 10b-5." *Id.* at 462.

which the defendant printer had no relation. Judge Kaufman stated that the fact "that appellant was not an insider of the companies whose securities he traded is true, but *irrelevant*. A financial printer such as Chiarella is as inside the market itself as one could be."<sup>47</sup> All "auxiliaries of the securities industry"<sup>48</sup> who regularly receive nonpublic market information would be classified as market insiders and would therefore be subject to the "disclose or abstain" rule of *Texas Gulf Sulphur*.<sup>49</sup>

In defining "market insider" the majority states that the concept bears a strong resemblance to the American Law Institute's defined category of "quasi-insider."<sup>50</sup> Although the concepts are similar in their effect, quasi-insiders are held liable only in "sufficiently egregious" situations.<sup>51</sup> No such limitation is imposed by *Chiarella*; the

47. 588 F.2d at 1364 (emphasis added).

48. *Id.* at 1365.

49. See notes 22-25 *supra* and accompanying text.

50. *Id.* at 1365.

51. ALI Fed. Securities Code §§ 1602(a), 1603 (March 1978 Draft). The more general provision relating specifically to "insiders" is § 1603 which states:

Sec. 1603 [*Insiders' duty to disclose when trading.*] (a) (General). It is unlawful for an insider to sell or buy a security of the issuer, if he knows a fact of special significance with respect to the issuer or the security which is not generally available, unless (1) the insider reasonably believes that the fact is generally available or (2), if the other party to the transaction (or his agent) is identified (A) the insider reasonably believes that the person knows it, or (B) that person in fact knows it from the insider or otherwise.

(b) ["*Insider*"]. "Insider" means (1) the issuer, (2) a director or officer of, or a person controlling, controlled by, or under common control with, the issuer, (3) a person whose relationship or former relationship to the issuer gives or gave him access to a fact of special significance about the issuer or the security that is not generally available, or (4) a person who learns such a fact from a person specified in section 1603(b) (including a person specified in section 1603(b)(4)) with knowledge that the person from whom he learns the fact is such a person, unless the Commission or a court finds that it would be inequitable, on consideration of the circumstances and the purposes of this Code (including the deterrent effect of liability), to treat the person specified in section 1603(b)(4) as if he were specified in section 1603 (b)(1), (2), or (3).

(c) [*Secondary Insiders.*] Section 1603 applies to an insider specified in section 1603 (b) (3) only to the extent that he knows a fact of special significance by virtue of his occupying that status.

*Id.* at 528-29. Section 1602(a) states:

Sec. 1602: [*Purchases, sales, proxy solicitations, tender offers, and investment advice.*] (a) [*General.*] It is unlawful for any person to engage in a fraudulent act or to make a misrepresentation in connection with (1) a sale or purchase of a security, an offer to sell or buy a security, or an inducement not to buy or sell a security, (2) a proxy solicitation or other circularization of security holders in respect of a security of

test for whether one is a market insider is his position within the market and whether he regularly receives material nonpublic market information.<sup>52</sup> The printer in *Chiarella* would most likely fall within the standards of both quasi-insider and market insider liability since under the facts of the case, as the majority notes, the printer's conduct could be classified as egregious due to the extent of his trading.<sup>53</sup>

The dissent in *Chiarella* criticizes the judicial extension of prior law.<sup>54</sup> Judge Meskill argues that the court has drifted into the legis-

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a registrant, (3) a tender offer or a recommendation to security holders in favor of opposition to a tender offer, or (4) activity or proposed activity as an investment advisor.

*Id.* at 523-24. The ALI recognized that the concept of corporate insider allowed a loophole in rule 10b-5 for those persons who had regular access to market information, but who did not have any relationship to the issuing corporation. The term quasi-insider labels such a person. The comments following § 1603 note that "[i]t would be convenient to have a new category of 'quasi-insider' that would cover people like judges' clerks . . . , Federal Reserve Bank employees . . ." and others with access to non-public information but no corresponding duty to the corporate source of that information. *Id.* at 538. The commentary continues, "[b]ut all this does not lend itself to definition." *Id.* The problem is resolved by the "juxtaposition of § 1603 with the more general § 1602, which is as broad as Rule 10b-5 is today." *Id.* at 539. While some quasi-insider cases might fall under § 1603(b) (3), "[b]ut, to the extent that a sufficiently egregious case of trading while silent cannot be rationalized on an 'insider' analysis, a plaintiff may fall back on § 1602 (a)(1)." *Id.*

52. See note 45 *supra* and accompanying text.

53. 588 F.2d at 1366.

54. As noted below the dissent also argues that the defendant's conviction should be reversed on due process grounds. See note 81 *infra* and accompanying text. A major distinction between the majority and dissenting opinions in *Chiarella* is the difference in the interpretation of *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). There the defendants were held civilly liable due to a special relationship as transfer agents to those who were selling securities on a differentiated market. The case involved a bank and the Ute Distributing Corporation (UDC) whereby the former was acting as transfer agent for the latter's stock. The stock was being sold by Indian owners to non-Indian purchasers. Thus, there were, in effect, two markets—the seller's market and the buyer's market. By not disclosing certain material information, the defendants induced the stockholders to sell in ignorance of an increased demand and higher price for the UDC stock. The Supreme Court of the United States held that the defendants violated an affirmative duty to disclose information to the selling stockholders. *Id.* at 152-54. In *Chiarella* Judge Kaufman's majority interpretation of the case finds that the defendant's "position at the center of the two markets gave rise to a Rule 10b-5 affirmative duty to disclose." 588 F.2d at 1366.

The key factor under this interpretation is the defendant's regular access to market information which is derived from the defendant's position between the split markets. Judge Meskill, however, notes that in *Affiliated Ute Citizens* it was not the defendant's position within the market which created the duty to disclose, but their active participation in a scheme to defraud which breached a fiduciary duty to the sellers. *Id.* at 1375 (Meskill, J.,

lative realm by judicially adopting the "quasi-insider" concept of the ALI proposal.<sup>55</sup> The dissent's objection to the majority's expansion of prior case law is based upon a policy against usurping the legislature's and the SEC's function to promulgate securities laws and regulations.<sup>56</sup>

The Second Circuit's decision in *Chiarella* is a logical and necessary extension of the disclose or abstain rule of *Cady, Roberts* and *Texas Gulf Sulphur*.<sup>57</sup> By expanding the scope of rule 10b-5 to include market insiders the court serves the purpose of maintaining trader confidence<sup>58</sup> in the securities market and fulfills the goal of equalizing the access to market information among traders.<sup>59</sup> The extension of liability to market insiders for violations of rule 10b-5 reflects an effort by the courts to maintain the remedial nature of the rule<sup>60</sup> and to go beyond the limits of common law fraud.<sup>61</sup> Thus it appears that the policy underlying *Chiarella* is that of promoting equality of access to information within the securities market.<sup>62</sup> Market insider liability is valid in that it is fair to conclude that a person should not be able to profit from a position in which he regularly receives nonpublic market information yet has no corre-

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dissenting). Therefore, "it was not the bank's clearly superior regular access to market information concerning UDC stock but its actions in undertaking to act for the sellers that rendered its silence equivalent to a scheme to defraud the selling shareholders." *Id.*

55. *Id.* at 1376 (Meskill, J., dissenting).

56. *Id.* The dissent states:

When a new weak point is identified—such as abuse of regular access to market information by certain participants in the industry—a direct attack on the problem through congressional legislation or SEC rulemaking would be a more appropriate response than the uncomfortable stretching of existing law engaged in by the majority here to cover the gap.

*Id.*

57. *But see* Note, 58 NEB. L. REV. 866 (1979), for the opposite conclusion: "Unfortunately, the creation of a market insider duty of disclosure appears before like some *a priori* principle without any clear indication that it is the next proper step in the evolution of rule 10b-5." *Id.* at 890.

58. *See* Fleischer, Mundeim & Murphy, *supra* note 43, at 816.

59. *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith Inc., 495 F.2d 228, 236 (2d Cir. 1974).

60. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); United States v. Persky, 520 F.2d 283 (2d Cir. 1975).

61. *See* Hooper v. Mountain States Sec. Corps., 282 F.2d 195, 201 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961).

62. *See* notes 58-59 *supra*. *See also* R. Siciliano, *U.S. v. Chiarella—A Step Toward Parity*, N.Y.L.J., Oct. 22, 1979, at 3, col. 1.

sponding duty or relationship to the ultimate corporate source of the information.

#### IV. Retroactive Application of Market Insider Liability in *Chiarella*

The most unsettling issue posed in *Chiarella*, one which has thus far received little attention, is the application of criminal liability to the defendant. Criminal liability is imposed for violations of "any provision" of the Securities and Exchange Act of 1934 and rules promulgated thereunder as provided by section 32(a) of the Act.<sup>63</sup> *Chiarella* represents the first instance in which a person was prosecuted for violating the anti-fraud provisions of rule 10b-5 in a non-disclosure situation. Notwithstanding the fact that courts have consistently held that civil precedents apply to criminal violations of the same act, the scope of insider liability has evolved entirely in the civil context.<sup>64</sup> It is submitted, therefore, that a due process problem arises from the Second Circuit's retroactive application of the expansive concept of market insider.

There have been few criminal cases involving violations of section 10b and rule 10b-5.<sup>65</sup> Furthermore, to date there have been no reported cases involving criminal liability for nondisclosure under rule 10b-5. In *United States v. Persky*<sup>66</sup> false statements and misrepresentations were made by a corporate executive in a scheme to cover up a loss due to improper investment of corporate funds.<sup>67</sup> The Second Circuit held that section 10b and rule 10b-5 were not so vague and ambiguous as to deny a defendant's right to due process in a criminal case.<sup>68</sup> In the court's opinion Judge Kaufman stated,

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63. Securities Exchange Act of 1934, 15 U.S.C. § 78 ff (a) (1976). § 32 (a) provides in part: § 78 ff. Penalties.

(A) Any person who willfully violates any provision of this chapter, or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter, . . . shall upon conviction be fined not more than \$10,000, or imprisoned not more than five years . . . .

64. See note 2 *supra* and accompanying text.

65. See 3 L. LOSS, *SECURITIES REGULATION* 1449 n.15 (2d ed. 1961); Mathews, *Criminal Prosecutions Under the Federal Securities Laws and Related Statutes: The Nature and Development of SEC Criminal Cases*, 39 GEO. WASH. L. REV. 901, 908 n.39 (1971).

66. 520 F.2d 283 (2d Cir. 1975).

67. *Id.* at 284-85.

68. *Id.* at 288. In *Persky*, the defendant claimed lack of fair notice because "expansive civil interpretations of Rule 10b-5 have so stretched the rule that he was not provided fair

"Perhaps the most interesting [issue] is the apparent dissonance between the general rule that criminal statutes are to be strictly construed in favor of the accused [citations omitted] and the realization that civil incarnations of the anti-fraud provisions have, as remedial legislation, been openly and avowedly construed broadly [citations omitted]."<sup>69</sup> This dissonance is evident in *Chiarella*. However the issue there is not whether the statute is too vague or ambiguous, but rather, whether the defendant had fair notice of the application of the concept of market insider liability.

In *United States v. Charnay*<sup>70</sup> the defendants attempted to deflate the price of a target corporation's stock in order to make their tender offer more attractive to a reluctant board of directors.<sup>71</sup> The Ninth Circuit Court of Appeals upheld the criminal conviction for violation of rule 10b-5 by relying on civil precedents.<sup>72</sup> Because *Charnay* involved a case of market manipulation, the disclose or abstain rule was not applicable; manipulation of the stock market is itself a prohibited type of fraud under rule 10b-5.<sup>73</sup> Unlike the court in *Chiarella*, this court did not have to determine whether or not the defendants were insiders since no such qualification is placed on the prohibition against market manipulation.

Thus, in *Persky* and *Charnay* the court established that civil precedents will apply in criminal prosecutions for violations of the anti-fraud provisions of the federal securities legislation, and that in such cases rule 10b-5 will be construed broadly.<sup>74</sup> Prior to

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warning that his conduct was fraudulent. . . ." *Id.* at 287. The court rejected this contention. However, *Persky* can be distinguished from *Chiarella*. In the latter case the defendant's claim of fair notice violation is not based on the stretching of civil precedent, but on the total lack of civil precedent which proscribed the conduct of market insiders. The earlier "printer cases" involved SEC enforcement proceedings in which the printers all entered into consent decrees in order to avoid litigation. Such an administrative proceeding, as Judge Meskill points out, should not be construed as a civil precedent proscribing the conduct of market insiders. 588 F.2d at 1377 n.6 (Meskill, J., dissenting).

69. 520 F.2d at 287.

70. 537 F.2d 341 (9th Cir.), cert. denied, 429 U.S. 1000 (1976).

71. *Id.* at 343-44. The scheme to willfully depress the market price of the target stock was perpetrated to induce Charnay and others to sell their stock in the target corporation with a secret guarantee of recovering a certain price after the sale.

72. *Id.* at 348.

73. See note 21 *supra* and accompanying text.

74. The Supreme Court has addressed this issue in *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) which was a civil action. In *Joiner* the defendants were accused of fraud in connection with the sales and assignments of oil and gas leases in violation of sections 5(a)

*Chiarella*, however, there was no judicial statement that market insiders would be held either civilly or criminally liable. This lack of civil precedent should prevent the retroactive application of market insider liability in a criminal case.

Due process requires "a clear and definite statement of the conduct proscribed."<sup>75</sup> The majority in *Chiarella* finds that the defendant was given adequate notice under the facts of the case since signs were posted throughout the printshop stating that criminal liability could result from the use of any information obtained during the course of employment.<sup>76</sup> The majority also notes that there have been several SEC enforcement proceedings against printers prior to *Chiarella's* market trading.<sup>77</sup> Judge Kaufman explained the relevance of the signs remarking, "*Chiarella's* conduct was rendered illegal by the language and policy of the statute and rule. The sign merely informed appellant of the SEC's view of the law—a view we

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and 17a(2) and (3) of the Securities Act of 1933. The SEC sought an injunction against the defendants making certain representations; the trial court and the Court of Appeals for the Fifth Circuit denied the injunction based on the determination that the assignments were not "securities" or investment contracts under section 2 (1) of the 1933 Act. *Id.* at 348. Therefore, the Supreme Court was concerned only with the narrow issue of defining a security. The defendants argued that a strict interpretation of the Act was required since potential criminal sanctions were involved for violations of the Act. The Supreme Court rejected this argument and explained that the liberal construction called for by the Securities Act precluded any argument for narrow construction. *Id.* at 353-54. As a result the defendants were enjoined from making further fraudulent representations. *Id.* at 355.

75. 520 F.2d at 288.

76. 588 F.2d at 1369. The signs throughout Pandick Press stated:

**TO ALL EMPLOYEES:**

The information contained in all type set and printing done by Pandick Press, Inc., is the private and personal property of the customer.

You are forbidden to use any information learned from customer's copy, proofs or printed jobs for your own or anyone else's benefits, friend or family or talking about it except to give or receive instructions. Any violation of this rule will result in your being fired immediately and without warning.

In addition, you are liable to criminal penalties of 5 years in jail and \$10,000 fine for each offense.

If you see or hear of anybody violating this, report it immediately to your supervisor or to Mr. Green or Mr. Fertig. Failure to report violations will result in your being fired.

*Id.*

77. See *SEC v. Manderano* [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,357 (D.N.J. 1978); *SEC v. Primar Typographers, Inc.* [1976-1977 Transfer Binder] FED. SEC. REP. (CCH) ¶ 95,734 (S.D.N.Y. 1976); *SEC v. Ayoub* [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,567 (S.D.N.Y. 1976); *SEC v. Sorg Printing Co.* [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,034 (S.D.N.Y. 1976).

today hold was correct."<sup>78</sup> In contrast, the dissent notes that the posted signs would be relevant to the issue of intent or knowledge, but "signs posted by a private party can hardly transform conduct otherwise not covered by a particular statute into conduct prohibited by that statute."<sup>79</sup>

The issue is thus squarely drawn: Is a nonjudicial statement prohibiting market insiders from trading on nonpublic information without disclosing that information fair notice to a defendant in a criminal case? In *Chiarella* it appears that the defendant's conduct was clearly culpable, but the culpability of the defendant alone cannot transform his conduct into criminal activity.<sup>80</sup> The dissent in *Chiarella* correctly concludes that due process requires a prior legislative or judicial pronouncement of the law before it may be applied in a subsequent criminal proceeding.<sup>81</sup>

The fair notice requirement was established by the Supreme Court specifically to apply to judicial interpretations which expanded criminal liability.<sup>82</sup> While the *ex post facto* clause of the Constitution<sup>83</sup> applies to legislative enactments which expand liability,<sup>84</sup> the fifth amendment due process clause requires an analogous prohibition against the retroactive application of expanded liability created by judicial interpretation.<sup>85</sup> The Supreme Court of the United States faced the problem of retroactive application of a judicial extension of criminal liability in *Marks v. United States*.<sup>86</sup> In this case the Court ruled that the retroactive application of a broad definition of pornography as stated in *Miller v. California*<sup>87</sup> deprived the defendant of the fair notice requirement of due process.<sup>88</sup> In *Marks* the defendants were convicted of transporting pornographic

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78. 588 F.2d at 1370 n.18.

79. *Id.* at 1379 (Meskill, J., dissenting).

80. *See, e.g., United States v. Zacher*, 586 F.2d 912, 916-17 (2d Cir. 1978).

81. 588 F.2d at 1377.

82. *See, e.g., Marks v. United States*, 430 U.S. 188, 192 (1977); *Bouie v. City of Columbia*, 378 U.S. 347, 353-54 (1964).

83. U.S. CONST. art. I, § 9, cl. 3.

84. *See United States v. Harriss*, 347 U.S. 612, 617 (1954); *Lanzetta v. New Jersey*, 306 U.S. 451, 453 (1939).

85. *See note 82 supra* and accompanying text.

86. 430 U.S. 188 (1977).

87. 413 U.S. 15 (1973).

88. 430 U.S. at 196.

material across state boundaries.<sup>89</sup> At the time of defendant's conduct the definition of pornography was governed by *Memoirs v. Massachusetts*,<sup>90</sup> but at the time of their trial and conviction the definition entailed the broader standard enunciated in *Miller v. California*.<sup>91</sup> Under *Memoirs* the standard required the work to be "utterly without redeeming social value"<sup>92</sup> to be pornographic. In *Miller* a more broad standard was enunciated; specifically, whether the work "lacks serious literary, artistic, political, or scientific value."<sup>93</sup> Thus, in *Marks* the Court held that the standard enunciated in *Miller* expanded criminal liability, and therefore, the retroactive application of the broader standard to the defendants' conduct violated the fair notice requirement of the fifth amendment due process clause.<sup>94</sup>

The Second Circuit did not address the issue raised in *Marks*. The majority in *Chiarella* concluded that the defendant had fair notice that his conduct could result in criminal liability. As noted above, this conclusion appears erroneous in that only judicial or legislative statements should provide fair notice. Whereas *Texas Gulf Sulphur* and *Cady, Roberts* indicated a broad reading of rule 10b-5, the financial community has hitherto read those cases as limiting liability to corporate insiders.<sup>95</sup> Notwithstanding the validity of the court's interpretation of rule 10b-5, holding *Chiarella* criminally liable is unwarranted.

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89. *Id.* at 191.

90. 383 U.S. 413 (1966).

91. 413 U.S. 15 (1973); *See also* *Marks v. United States*, 430 U.S. 188, 190-91 (1977).

92. 383 U.S. at 418.

93. 413 U.S. at 24.

94. 430 U.S. at 196. The majority of the Court concluded that the case should be remanded for a new trial based on the standards of *Memoirs v. Massachusetts*, 383 U.S. 413 (1966); Justice Brennan with Justice Marshall joining in a partial dissent agreed that the fair notice requirement of the due process clause was violated, but they felt that no new trial should be ordered. Justice Stevens concurred in the majority opinion but also objected to the remand for a new trial.

95. Evidence of the community's concern over market insider liability is shown in the many articles that have been written. *See generally* Case Comment, 92 HARV. L. REV. 1538 (1979); Recent Decision, 13 GA. L. REV. 636 (1979); Note, 58 NEB. L. REV. 866 (1979); Brodsky, *Trading on Non-Public Market Information*, N.Y.L.J., June 21, 1979, at 2, col. 1; Siciliano, *U.S. v. Chiarella — A Step Toward Parity*, N.Y.L.J., October 19, 1979, at 1, col. 2.

## V. Conclusion

*Chiarella* stands as a beacon to all individuals who regularly receive nonpublic market information that they may not trade in the securities market without first disclosing their specific knowledge. Such a rule promotes equality of access to market information, and therefore tends to equalize the risk among purchasers and sellers in securities transactions. The rule of disclosure as applied to market insiders has been implied in prior case law and its application in *Chiarella* is a logical extension of these precedents. Affirmance of the concept of market insider liability would signal to the financial community that the integrity of the market should be scrupulously protected.

An affirmance of the defendant's criminal conviction in this case would be an unconstitutional retroactive application of a criminal sanction. Notwithstanding evidence which indicates that *Chiarella* knew of possible illegality in his conduct, the legal and financial community apparently considered *Chiarella's* conduct distinctly outside the class of insiders to which rule 10b-5 applies in nondisclosure cases. Where there exists a reasonable basis for a conclusion that no fair notice was provided a criminal sanction is unwarranted and constitutionally questionable.

*John J. Murphy*