Rule 10b-5 -- Insider Transactions by Brokers

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CASES NOTED

RULE 10b-5 — INSIDER TRANSACTIONS BY BROKERS

At a corporate directors' meeting it was decided to lower the quarterly dividend. Due to technical delays, this information was not transmitted to the New York Stock Exchange or the Dow Jones Ticker Service until approximately one hour after the directors had authorized the release of the information. However, during a recess of the meeting, and before the news reached the Exchange, a director telephoned the office of a broker-dealer firm of which he was a registered representative, and left a message for a partner in the firm that the dividend had been cut. Thereupon, the partner put in two sell orders for discretionary accounts for execution on the Exchange, without waiting for the public disclosure of the dividend cut. Held: the nondisclosure of a material fact known to one by virtue of his position, but which is not known to persons with whom he may deal, and which, if known, would affect their investment judgment, violates the anti-fraud provisions of the securities acts and the rules promulgated thereunder. Cady, Roberts & Co., SEC Securities Exchange Act Release No. 6668 (Nov. 8, 1961).¹

Section 17(a)² of the Securities Act of 1933, section 10(b)³ of the Securities Exchange Act of 1934, and rule 10b-5⁴ (promulgated by the Securities and Exchange Commission under the latter act) are intended to prevent the corporate “insider” from taking unfair advantage of information he obtains because of his position in connection with the sale of the corporation’s securities.⁵ These “insider” regulations have traditionally

1. Although the Commission found that both the partner and the partnership had violated the anti-fraud provisions, it did not punish the firm, and only suspended the partner for twenty days from the New York Stock Exchange.
4. “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.” 17 C.F.R. § 240.10b-5 (1949). (Emphasis added.) For a summary of the state law in this area see Conant, Duties of Disclosure of Corporate Insiders Who Purchase Shares, 46 Cornell L.Q. 53 (1960).
5. Conant (supra note 4, at 60) points out that most “insider” cases involve com-
been applied to, and the word itself defined in terms of corporate officers, directors and controlling stockholders.\(^6\) They have been held to give a seller the right of recovery for his lost profits;\(^7\) a buyer recovery for his losses;\(^8\) and the SEC grounds for prosecution for violation of the various anti-fraud provisions.\(^9\) These provisions have been held not to extend to fraud perpetrated on one other than a buyer or a seller.\(^10\) In some cases, under sections 16(a) and (b)\(^11\) of the Exchange Act, the corporation may recover the profits so derived by the insider.

The instant decision is an unequivocal and intentional expansion of the scope of rule 10b-5 and the definition of "insider." The Commission stated:

We have . . . noted that the anti-fraud provisions are phrased in terms of "any person" and that a special obligation has been traditionally required of corporate insiders, e.g., officers, directors and controlling stockholders. These three groups, however, do not exhaust the classes of persons upon whom there is such an obligation.\(^12\)
The respondent (partner) comes within the "any person" phrase because of his "relationship giving access . . . to information" and the "inherent unfairness" in the transaction.\(^{13}\)

The respondents (both the partner and the firm) contended, on the basis of Joseph v. Farnsworth Radio & Television Corp.,\(^{14}\) that rule 10b-5 could not apply because they had no privity with those who bought the shares. The Commission pointed out that although the Farnsworth case required privity for a suit by the private party, this action was instituted by the SEC and "the absence of a remedy by the private litigant because of lack of privity does not absolve an insider from responsibility for fraudulent conduct."\(^{15}\)

The respondent further argued that this ruling places the broker in the position of carrying out his fiduciary duty to his client at the risk of SEC sanctions for the breach of a nonfiduciary duty to an unknown investor. The Commission answered that the existence of a dilemma, in which any choice of action will damage someone, does not justify the choice that happens to be beneficial to the one making the choice. To the broker who is in doubt as to whether a contemplated transaction is prohibited by the anti-fraud provisions, the Commission says, "forego the transaction."\(^{16}\) Thus, there is no difference between the insider who must renounce his own gain and one who must give up the gain for his client.\(^{17}\)

Although the present decision appears to expand the scope of rule 10b-5 only in the definition of an "insider," the Commission has taken a step that may lead to SEC prosecution (and possibly private litigation) against all those who knowingly deal "unfairly" with inside information.\(^{18}\) The traditional application of rule 10b-5 only to officers, directors and controlling stockholders seems to have stemmed mainly from the imprac-

13. Ibid.
14. 99 F. Supp. 701 (S.D.N.Y. 1951), aff'd per curiam, 198 F.2d 883 (2d Cir. 1952). This case held there must be a "semblance of privity" between the defrauded buyer and the seller, and that privity was lacking when the buyers bought the securities thirteen and forty-four days after the insider had sold them on the exchange. This case has been greatly criticized on the ground that the seller knew someone would be defrauded by his act. See the dissent by Judge Frank in the appellate decision supra at 887; Latty, supra note 7, at 521; Note, 42 VA. L. REV. 537, 569-72 (1956); 68 HARV. L. REV. 1290-91 (1955); 4 STAN. L. REV. 308 (1952).
16. Id. at 10. On this dilemma and the problems of disclosure, the open exchange and conflicting duties, see generally Loss, op. cit. supra note 6, at 1455-56; Leech, Transactions in Corporate Control, 104 U. PA. L. REV. 725, 769-74 (1956); Comment, 59 YALE L.J. 1120, 1142-47 (1950); Berle, Publicity of Accounts and Directors' Purchase of Stock, 25 Mich. L. Rev. 827, 837 (1927).
17. It should be pointed out that the use of information derived from analysis and study has not been jeopardized by this decision.
18. Many writers have argued for expansion of the scope of rule 10b-5. See Loss, op. cit. supra note 6, at 1451; Latty, supra note 7, at 521; Note, 39 CALIF. L. REV. 429, 438-39 (1951); Note, 42 VA. L. REV. 537, 564-77 (1956).
tacticality of enforcing rules with more comprehensive applicability. But this approach is constricting because it focuses on who an insider is rather than what he did. Under this former approach, "any person" meant "any insider," with a narrow definition of "insider" which limited the scope of rule 10b-5. In the present case, even though the Commission mentioned the broker's "special relationship with the company"\(^{19}\) in its explanation of the "any person" phrase, there is more emphasis on the "inherent unfairness" of the transaction and the exploitation of the uninformed investor than in previous cases. In the words of the Commission, "intimacy demands restraint lest the uninformed be exploited."\(^{20}\)

Difficulties of enforcement may create an impasse to the expansion of rule 10b-5 to all who knowingly use inside information, but the greatest obstacle in the way of more stringent application to brokers seems to be the business practices of the brokers themselves. One broker has said, "a broker who never had an iota of inside information would soon find himself out of business, for the good and sufficient reason that he would know little more than his customers."\(^{21}\) He also said that brokers abstain, not because of the SEC rules, but because so much of this information is false. This rationalization is no more salve to the insider's victim than is the hollow echo of caveat emptor. The instant decision rejects these "morals of the market place" and is a clear indication that the SEC is no longer satisfied to let brokers regulate themselves in this area.

ALEXANDER C. ROSS

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**DUE PROCESS — REVOCATION OF A DRIVER'S LICENSE WITHOUT A HEARING UNDER THE FLORIDA FINANCIAL RESPONSIBILITY ACT**

The plaintiff, an uninsured motorist, was involved in an automobile accident. He failed to comply with the provisions\(^1\) of the Financial Responsibility Act,\(^2\) and the commissioner\(^3\) threatened to revoke his driver's license and registration certificate. The plaintiff sought injunctive relief to restrain the commissioner and a final decree adjudicating the act as violative of

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20. Ibid.