SECURITIES REGULATION: RULE 10b-5 UNDER SECURITIES EXCHANGE ACT OF 1934 HELD NOT TO REQUIRE PRIVITY FOR PRIVATE RECOVERY

IN THE recent case of *Cochran v. Channing Corp.*,[1] the District Court for the Southern District of New York held that rule 10b-5 under section 10 (b) of the Securities Exchange Act of 1934[2] imposes a duty upon corporate insiders, notwithstanding a lack of privity between the parties, to disclose "material facts" to sellers of stock prior to engaging in their own personal dealings in the stock. It is not unusual for a court to construe rule 10b-5 to impose on insiders such a duty of disclosure when the parties with whom they are dealing are in privity, but the extent to which the duty will be recognized to support private recovery in the absence of privity between the parties has not been clearly defined.

In the *Cochran* case, individual defendant insiders, who were directors of both defendant Channing Corporation (Channing) and Agriculture Insurance Company (AIC), were alleged to have caused Channing to secretly purchase controlling interest in AIC and to have used their control position to intentionally reduce AIC's dividend rate and thereby enable the purchase of additional shares at depressed prices. Plaintiff sought to recover for his loss on the sale of 500 AIC shares made in reliance on the dividend reduction as indicative of depleted value, contending that defendants' course of conduct was a violation of rule 10b-5. Defendants moved for dismissal on the grounds that section 10 (b) and rule 10b-5 there-

[1] 211 F. Supp. 239 (S.D.N.Y. 1962).

[2] "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 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." Securities Exchange Act of 1934, § 10 (b), 48 Stat. 891, 15 U.S.C. § 78j (1958) [hereinafter referred to as Exchange Act].

Rule 10b-5, prescribed under § 10 (b) of the Exchange Act, makes it "unlawful . . . (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." 17 C.F.R. § 240.10b-5 (1949).

under both require privity of contract, and, in any event, no violation had occurred since no verbal misrepresentations had been made. In dismissing the motion, the court stated that the lack of privity, though a factor to be considered, does not preclude recovery in the context of the alleged facts, and that rule 10b-5 can be violated without making any statements whatsoever.[3] The court further held that rule 10b-5 imposes upon an insider the duty to disclose facts which would materially affect the judgment of the other party to the transaction.[4]

The duty of an insider to disclose material facts was an early common law development, which arose because of the insider's position in a corporation which affords him access to information not available to the ordinary investor.[5] The degree and character of disclosure presently required at common law varies depending upon which of three basic views is followed by a particular jurisdiction. Initially no fiduciary duty was recognized between insiders and investors; thus an insider was required only to refrain from active misrepresentation.[6] The harsh treatment of investors frequently resulting under this rule has led a few jurisdictions to adopt an approach which treats the insider as a fiduciary and requires him to fully disclose and explain all material facts to the person with whom he is trading.[7] While this view is not widely accepted, a third approach has been embraced by a large and growing number of jurisdictions which similarly acknowledge the injustice of the older rule. These jurisdictions hold that "special circumstances" sometimes exist which give rise to a duty of disclosure.[8] Under

[3] 211 F. Supp. at 243. The facts of a particular case need not fall within the language of all three clauses in order to constitute a violation of rule 10b-5. While it is probable that their areas of operation overlap, it is sufficient if any one of the clauses proscribes the activity in question. See Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (D. Del. 1951); In the Matter of Cady, Roberts & Co., SEC Securities Exchange Act Release No. 6668 (Nov. 8, 1961), text at nn.12 & 19; Meisenholder, *Scienter and Reliance as Elements in Buyer's Suit Against Seller Under Rule 10B-5*, 4 CORP. PRACT. COMM. 27, 29-30 (1963).

[4] 211 F. Supp. at 243.

[5] See LATTIN, CORPORATIONS 262-66 (1959); 3 LOSS, SECURITIES REGULATION 1446-48 & nn.4-8 (2d ed. 1961) [hereinafter cited as Loss]; Berle, *Publicity of Accounts and Directors' Purchases of Stock*, 25 MICH. L. REV. 827 (1927).

[6] See, *e.g.*, Carpenter v. Danforth, 52 Barb. 581 (N.Y. 1869); see Walker, *The Duty of Disclosure by a Director Purchasing Stock from His Stockholders*, 32 YALE L.J. 637 (1923); Annot., 84 A.L.R. 615 (1933).

[7] See Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903); Hotchkiss v. Fischer, 136 Kan. 530, 16 P.2d 531 (1932).

[8] The leading case for this view is Strong v. Repide, 213 U.S. 419 (1909). For the

none of the three theories, however, has recovery been allowed without privity between the parties.[9]

These common law actions, although still available, generally proved to be insufficient to adequately protect the ordinary investor. Insiders, through manipulation of the market and use of information available only to themselves, found little difficulty in using their corporate positions to personal advantage.[10] The unstable market conditions resulting from such abusive practices prompted federal legislation aimed at renewing investor confidence in securities. The Securities Exchange Act of 1934[11] containing a battery of regulatory provisions resulted. Section 16 (b)[12] of that act has been one of the most effective weapons against unfair use of information by insiders. Under this section a corporation itself can recover all profits which an insider has realized by trading in the corporation's securities within any six-month period.[13] Sections 9 and 10 (a)[14]

suggestion that courts are moving toward the fiduciary rule by applying and expanding the "special circumstances" doctrine, see 3 Loss 1447; STEVENS, PRIVATE CORPORATIONS 696 (1949).

[9] See Rubin & Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders*, 95 U. PA. L. REV. 468, 497 (1947).

While there are no cases directly on point, in a Massachusetts case involving the purchase by directors of their corporation's stock on an exchange, the court stated that such sales were impersonal in nature and that directors could not be expected to seek out the ultimate party to the transaction in order to make disclosures. The court further indicated that business of this type should be governed by practical rules and not burdened by onerous duties; however, where a director deals directly with a stockholder, the transaction will be more closely examined. Goodwin v. Agassiz, 283 Mass. 358, 362-63, 186 N.E. 659, 661 (1933). See LATTIN, CORPORATIONS 265-66 (1959); Walker, *supra* note 6. *But see* BALLANTINE, CORPORATIONS 215, 216 (rev. ed. 1946).

Requiring the insider to disclose to all selling stockholders would, if anything, increase the practical difficulties whether the sale was effected on or off an exchange. Furthermore the extent of the disclosure required depends upon the circumstances peculiar to the relationship of the insider and the particular stockholder with whom he is trading, and it is only to this stockholder that disclosure *must* be made, though disclosure through general channels may be sufficient. See Taylor v. Wright, 69 Cal. App. 2d 371, 159 P.2d 980 (1945); Stewart v. Harris, 69 Kan. 498, 77 Pac. 277 (1904); FLETCHER, PRIVATE CORPORATIONS §§ 1168.2, 1171 (perm. ed. rev. repl. 1947); Berle, *supra* note 5, at 831.

[10] See *Hearings before the Senate Committee on Banking and Currency on S. Res. 84, S. Res. 56 and S. Res. 97*, 72d Cong., 1st and 2d Sess. 653, *passim* (1932-1934).

[11] 48 Stat. 881 (1934), as amended, 15 U.S.C. § 78 (1958), as amended (Supp. II 1961).

[12] Exchange Act § 16, 48 Stat. 896 (1934), 15 U.S.C. § 78p (1958). For discussions of § 16, see 2 Loss 1037-81; Rubin & Feldman, *Statutory Inhibitions Upon Unfair Use of Corporate Information by Insiders*, 95 U. PA. L. REV. 468 (1947).

[13] From the standpoint of the shareholder who has lost money, however, there are obvious limitations to an action under § 16 (b) of the Exchange Act: (1) Any recovery inures only to the benefit of the corporation, (2) no action is available against the insider who can afford to be patient and take his profit after the six-month

also serve as effective deterrents to insider manipulations by specifically prohibiting certain undesirable practices in securities transactions. Section 10 (b), involved in the instant case, generally prohibits the use of any manipulative or deceptive device in connection with the purchase or sale of any security.

Although section 10 (b) does not specifically provide private right of action for individual buyers or sellers, nevertheless, courts have generally recognized such a right and allowed private recovery.[15] While the pre-requisites of recovery under rule 10b-5 have not been clearly defined, they apparently are not limited by the elements of common law deceit.[16] Courts generally construe rule 10b-5 as incorporating the common law duty of disclosure[17] and requiring

period has elapsed, and (3) the period in which an action can be brought is limited to 2 years. 48 Stat. 896 (1934), 15 U.S.C. § 78p (1958).

In the case of the attorney-plaintiff, however, there may be adequate financial incentive in bringing these suits in that reasonable attorney's fees can be deducted from the recovery.

[14] Exchange Act §§ 9, 10 (a), 48 Stat. 889 (1934), 15 U.S.C. §§ 78i, j (a) (1958).

[15] The first case so holding was Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), *hearing on the merits after motion to dismiss denied,* 73 F. Supp. 798 (E.D. Pa.), *on request for further findings,* 83 F. Supp. 613 (E.D. Pa. 1947). This case has been consistently followed. See, *e.g.,* Fratt v. Robinson, 203 F.2d 627 (9th Cir. 1953); H. L. Green Co. v. Childree, 185 F. Supp. 95 (S.D.N.Y. 1960).

Most courts justify the existence of a private right of action on the tort theory that violation of a statute is a wrongful act for which civil liability should be available if the interest invaded is one which the statute intended to protect. Kardon v. National Gypsum Co., *supra* at 513. But see Comment, 1962 DUKE L.J. 423, 432-35 suggesting that this theory, having developed in terms of negligence, is of doubtful relevance when applied to federal securities legislation.

Other courts take the position that the 1938 amendment to § 29 (b) of the Exchange Act, creating a short statute of limitations on actions brought for violation of § 15 (c) (1) (but not expressly providing for a private action), implies that Congress had always assumed that private actions were available. See Mills v. Sarjem Corp., 133 F. Supp. 753 (D.N.J. 1955); Geismar v. Bond & Goodwin, Inc., 40 F. Supp. 876 (S.D. N.Y. 1941); Comment, 59 YALE L.J. 1120, 1134 (1950). But see 3 LOSS 1757-60, where it is suggested that the provisions of § 29 (b) can apply only when there is privity of contract between plaintiff and defendant.

Perhaps the best explanation for finding a private right of action for violation of the Exchange Act is the necessity of such action to effectively carry out the purposes of the legislation. See Baird v. Franklin, 141 F.2d 238, 244-45 (2d Cir. 1944) (Clark, J., dissenting in part) (involving a similar implied liability under § 6 (b)); *cf.* SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344, 350 (1943) (commenting on principles of statutory construction).

[16] "In general, the type of conduct which subjects one to liability for deceit consists of (1) false representations (2) fraudulently made (3) with the intention of inducing another to rely thereon. If such misrepresentations (4) induce reliance (5) and the reliance is justified and (6) causes damage, the defendant is liable." 1 HARPER & JAMES, TORTS 528 (1956).

[17] The proposition that rule 10b-5, quoted in note 2 *supra,* encompasses the duty of an insider to disclose material facts, does not rest primarily on any one of the three clauses. Rather, the duty is implicit in each of the three clauses, thus, failure

insiders "to disclose a fact coming to their knowledge by reason of their position, which would materially affect the judgment of the other party to the transaction."[18] While in the *Cochran* case the court based its decision on the failure of defendants to meet this duty, it would appear that recovery under rule 10b-5 need not have depended upon the disclosure rule. The court could have rested its decision on defendants' efforts to bring about the loss complained of, since these efforts indicate the existence of a scheme to defraud which would have constituted a violation of at least clauses (1) and (3) of rule 10b-5.[19]

In view of the available alternative grounds for the decision and the fact that the disclosure rule, at least at common law, requires privity, the court's recognition in the *Cochran* case of the statutory duty of an insider to disclose, may have implications as to the nature of a rule 10b-5 action. While recovery under rule 10b-5[20] is said not to be limited by the elements of common law deceit,[21] nevertheless, it is thought likely that it does retain the requirements of reliance[22] and at least "watered-down" scienter.[23] However, at

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to disclose may be a violation of one or all three. See Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (D. Del. 1951); In the Matter of Cady, Roberts & Co., SEC Securities Exchange Act Release No. 6668 (Nov. 8, 1961), text at n.19.

[18] 211 F. Supp. at 243. The court's statement of the rule is taken from Kardon v. National Gypsum Co., 73 F. Supp. 791, 798 (E.D. Pa. 1947). For a discussion of what has been considered a material fact requiring disclosure, see Comment, 59 YALE L.J. 1120, 1145-46 (1950); Note, 40 MINN. L. REV. 62, 69-73 (1955).

[19] Plaintiff, in effect, alleged that defendant lowered the dividend rate which falsely implied a depleted value of the stock; that this was done with the intention of deceiving other stockholders as to the true value and inducing them to sell at a price reflecting a depletion of value; and that plaintiff, a stockholder, had relied on defendants' action to his detriment. Thus, the allegations satisfy all the elements of common law deceit as listed in note 16 *supra,* and certainly should satisfy any requirements of an action under clauses (1) and (3) of 10b-5, quoted in note 2 *supra. Accord,* Von Au v. Magenheimer, 126 App. Div. 257, 110 N.Y. Supp. 629 (1908), *aff'd per curiam,* 196 N.Y. 510, 89 N.E. 1114 (1909) (similar fact situation except that privity existed between the parties); see BALLANTINE, CORPORATIONS 216 (rev. ed. 1946); STEVENS, PRIVATE CORPORATIONS 695 (2d ed. 1949).

In the *Cochran* case the court stated, without mentioning the duty of disclosure, that "One who causes a reduction of dividend in order more cheaply to purchase the shares of a corporation is most certainly employing a device to defraud and is engaging in a course of business which operates as a fraud upon the seller of those securities." 211 F. Supp. at 243.

[20] For the text of rule 10b-5, see note 2 *supra.*

[21] See, *e.g.,* Hughes v. SEC, 174 F.2d 969, 975 (D.C. Cir. 1949); Texas Continental Life Ins. Co. v. Bankers Bond Co., 187 F. Supp. 14 (W.D. Ky. 1960), *rev'd on other grounds sub nom.,* Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242 (6th Cir. 1962).

[22] See, *e.g.,* Kohler v. Kohler Co., 208 F. Supp. 808, 823 (E.D. Wis. 1962); Nash v. J. Arthur Warner & Co., 137 F. Supp. 615, 618 (D. Mass. 1955); Latty, *The Aggrieved Buyer or Seller or Holder of Shares in a Close Corporation Under S.E.C. Statutes,* 18

common law, where a duty to disclose is found, the presence or absence of scienter and reliance is not determinative.[24] Similarly, if recovery under rule 10b-5 is based upon such a duty to disclose, the presence or absence of scienter and reliance should likewise not be determinative.

The material fact not disclosed by the defendants in the *Cochran* case was described by the court to be their "true reason for the dividend cut."[25] Taken literally, this language is broad enough to require disclosure of all siguificant reasons or motivations for corporate action. This, however, is not the typical disclosure requirement; nor is such a broad interpretation justified in the instant case when the court's statement is viewed in light of the facts involved. Disclosure was made imperative in the *Cochran* case by the elements of improper self-interest and intention to mislead. It would seem that in the absence of these elements, a distinction should be drawn between motivations for taking action where the results are still speculative and motivations when the results are no longer uncertain.[26] The present case, of course, involved the latter situation,

LAW & CONTEMP. PROB. 505, 526-27 (1953). *Contra,* Texas Continental Life Ins. Co. v. Bankers Bond Co., *supra* note 21; Kardon v. National Gypsum Co., 83 F. Supp. 613 (E.D. Pa. 1947). *But see* 3 Loss 1765, where it is noted that several courts have simply assumed that reliance is a requirement and that the question is still open.

To a certain extent the requirement of reliance is inherent in the concept of materiality, but in that context it would seem to be a separate consideration and be resolved in terms of whether *anyone* would rely, rather than by determining the actual reliance of the particular defendant. See note 24 *infra; cf.* 3 Loss 1438.

[23] See, *e.g.,* Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); Thiele v. Shields, 131 F. Supp. 416 (S.D.N.Y. 1955); Seward v. Hammond, 8 F.R.D. 457 (D. Mass. 1948). *Contra,* Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Kohler v. Kohler Co., 208 F. Supp. 808 (E.D. Wis. 1962). See Meisenholder, *supra* note 3, at 43-44, 47.

[24] If scienter and reliance were required, there would be no distinction from an action in deceit. Although most commentators and courts discuss the duty of disclosure from the pragmatic standpoint of concrete situations without considering the basis of the liability, it has been suggested that liability is not based on silence as equivalent to an implied representation, but rather on the failure of defendant to live up to an ethical standard of conduct formulated by society for the general circumstances involved. Keeton, *Fraud–Concealment and Non-Disclosure,* 15 TEXAS L. REV. 1, 31-40 (1936). While scienter and reliance may sometimes play a part in creating the situation imposing the duty, they need not be present in all circumstances. See BOWER, ACTIONABLE NON-DISCLOSURE 275-77 (1915); 1 HARPER & JAMES, TORTS 590 (1956); PROSSER, TORTS 535 (2d ed. 1955).

[25] 211 F. Supp. at 243.

[26] *Compare* Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947), *and* Agatucci v. Corradi, 327 Ill. App. 153, 63 N.E.2d 630 (1945) (later sale assured), *with* James Blackstone Memorial Library Ass'n v. Gulf, Mobile & O. R.R., 264 F.2d 445 (7th Cir. 1959) (ultimate sale at a profit was but a hope).

When dealing in their corporation's stock, insiders' opinions concerning the future results of corporate action are generally considered dangerous to the other party. See Comment, 59 YALE L.J. 1120, 1148 (1950). In common law actions based on since at the time the duty arose, the desired depression of prices had been obtained.

In determining whether plaintiff was entitled to recover for defendants' failure to disclose, the lack of privity between the parties was viewed by the court as only an evidentiary fact to be considered. In so doing, the court followed its earlier statement in *Brown v. Bullock*,[27] where it had noted three factors to be considered: first, the relationship between the parties; secondly, the nature of defendants' participation in the transaction; and thirdly, plaintiff's reliance upon the defendants' act. These factors indicate that in the *Cochran* case, when determining the necessity of privity, the court was greatly influenced by the presence of both scienter and reliance. Moreover, this suggests that the court intended to define the "material fact" which defendants had a duty to disclose to include the entire scheme to defraud.

Certainly, where an insider through affirmative action has created the situation which enables him to take advantage of the seller's (or buyer's) reliance and lack of knowledge, a duty to disclose should be found even though privity does not exist. The modern trend of common law decisions does not require privity in an action for deceit;[28] neither where scienter and reliance are present should it be required under rule 10b-5, even if the action is based on nondisclosure. The latter situation is descriptive of the *Cochran* case. Though there was no privity between the buyer and seller, plaintiff did allege reliance and the court found that the defendants "not only failed to disclose a material fact . . . but were themselves responsible for its very existence."[29]

The same result should clearly follow even though an insider

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deceit, defendants have frequently sought to escape liability by contending that their statements were merely expressions of opinion on which plaintiffs had no right to rely. See Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 235-38 (1933). While the accuracy of that contention is not relevant to the instant case, it does suggest the paradox of requiring disclosure of opinions when applying rule 10b-5 to the same general problem.

[27] 194 F. Supp. 207, 229-30 (S.D.N.Y. 1961).

[28] RESTATEMENT, TORTS § 531 (1938), subject to the exceptions of § 532 and §536, limits liability to those persons whom the defendant intended to act in reliance. But where the defendant's action was intended to affect the market price in order that he might profit by transactions on the market, it would take a very narrow interpretation of his intention to include within it only those persons that ultimately sold or purchased stock from him. See 1 HARPER & JAMES, TORTS 530 (1956). In addition, some modern cases have held that it is sufficient that the defendant should have foreseen or contemplated plaintiff's reliance. See PROSSER, TORTS, 523, 540-41 (2d ed. 1955).

[29] 211 F. Supp. at 243.

has not by affirmative action created a situation beneficial to him, if he has taken advantage of it and privity exists between the parties. Though this is not the common law rule with respect to transactions occurring on an exchange, it has been suggested that even then an insider should not be free of his duty to disclose;[30] rather he should be required to make necessary publication of all material facts.[31] There has been no attempt to impose civil liability in this situation under rule 10b-5, but it seems clear that the SEC interprets the rule as requiring the insider to make adequate disclosure or, if this is prevented by practical difficulties, to refrain from trading.[32] However it is doubtful that this interpretation can be extended to support recovery by those persons not in privity with the insider. Under those provisions of the securities legislation which expressly provide for civil liability, recovery is specifically limited by the requirement of privity or other restrictions.[33] It can be inferred from this legislative pattern of restricting recovery where liability is expressly provided, that Congress did not intend to allow recovery under rule 10b-5 where there was no privity and an insider has not taken affirmative action.[34]

Of course, when viewed in the context of the legislation in which it is incorporated, the disclosure rule may serve to better promote the general purposes of the act without attaching the stumbling block of privity.[35] However, if the disclosure rule is used in this

[30] BALLANTINE, CORPORATIONS 215, 216 & n.95 (rev. ed. 1946).

[31] See Comment, 32 MICH. L. REV. 678, 684-85 (1934); Comment, 59 YALE L.J. 1120, 1149 (1950).

[32] See In the Matter of Cady, Roberts & Co., SEC Securities Exchange Act Release No. 6668 (Nov. 8, 1961) (partner in a broker-dealer firm suspended from the New York Stock Exchange for selling stock prior to public announcement of a dividend cut of which he had been informed by a director).

[33] Neither § 9 (e) nor § 18 of the Exchange Act require privity but they specifically require reliance and place a difficult burden of proof relative to causation on the plaintiff. Also both sections have a short statute of limitations, and § 18 allows the defendant to raise an affirmative defense by showing that he, in good faith, had no knowledge that the statement was false or misleading. Concerning § 16 (b) see note 13 *supra*.

[34] In the judicial allowance of a private right of action under § 10 (b) of the Exchange Act, the argument was made and rejected that Congress, having expressly provided for civil liability under some sections, did not intend such liability under any other sections. Fratt v. Robinson, 203 F.2d 627, 631-32 (9th Cir. 1953); Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946). However, it is one thing to assume congressional intention for a private right of action under § 10 (b) in order to carry out the purposes of the act, but quite another, in view of the express liability restrictions, to assume that recovery without limitation would also carry out congressional intention.

[35] Contrary to the common law disclosure rule which was designed to prevent insiders from taking unfair advantage of minority stockholders, the securities legisla-

manner, the possibility exists that an insider may be held liable for damages bearing no reasonable relationship to the amount of profit obtained by him.[36] This result runs counter to the previously discussed congressional policy of limiting civil liability under the act. Furthermore, when an insider has in his possession material information which he does not use to his personal advantage, no liability attaches,[37] though certainly the general purposes of the act would also be served by requiring disclosure in such an instance. It would appear that since the failure to disclose will result in the same loss to investors, the only significant distinction between the use and non-use of the information exists in the profit obtained. Therefore, it would seem that any liability for use of the information should also be related to the profit obtained. It is not essential that this limitation be accomplished through the requirement of privity, but apparently there are no other restrictions presently available. In view of these considerations, the use of the disclosure rule to impose civil liability without privity and without action by the defendant would be a questionable means of furthering the general purposes of the act.[38]

No court, however, has been faced with this particular situation, and all cases dispensing with the requirement of privity under rule 10b-5 have involved situations wherein there was some affirmative action by the defendant and some form of reliance by the plaintiff.[39] The caution expressed in these cases suggests that where there

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tion bas the broader purpose of insuring the investor adequate information from which to make an intelligent judgment. Both the disclosure provisions and the prohibitions of manipulative practices operate to achieve this result. *Compare* Berle, *Publicity of Accounts and Directors' Purchases of Stock,* 25 MICH. L. REV. 827, 828 (1927), *with* H.R. REP. No. 1383, 73d Cong., 2d Sess. 11, 13, *passim* (1934).

[36] While this may be consistent with the tort concept on which civil liability is based, it is probably too great a change from the common law position for the courts to take without statutory impetus. See LATTIN, *supra* note 5; Meisenholder, *supra* note 3, at 55. *But cf.* 3 Loss 1455-56.

[37] Defendant as well as plaintiff must be a purchaser or seller where liability is predicated strictly on non-disclosure without other evidence of a scheme to defraud. See Donovan, Inc. v. Taylor, 136 F. Supp. 552 (N.D. Cal. 1955).

[38] One taking the opposite view could well argue that the possibility of harsh results will have the desired effect of encouraging disclosure of all pertinent information. It is also likely that many stockholders would never pursue potential claims, so that in practice damages might not prove unreasonable. This argument might be concluded by asking why "dishonest directors should . . . find absolution . . . by concealing their identity . . . under the mask of the stock exchange." BALLANTINE, CORPORATIONS 216 (rev. ed. 1946).

[39] See Errion v. Connell, 236 F.2d 447 (9th Cir. 1956) (defendants knowingly cooperated in the fraud); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951) (plaintiffs alleged reliance on a prospectus prepared by defendants); Brown v. Bullock,

is non-disclosure without other deception, privity will be required. While under the present statutory scheme this appears to be the proper result, it does indicate the existence of a loophole in the fraud proscriptions since no one will have standing to bring suit against the insider who does not reap his profits within a six-month period. The extent to which the fraud provisions may be ignored, however, is mitigated by the possibility of administrative sanctions by the SEC.[40] Also a certain amount of disclosure is required by the Exchange Act requirement for periodic reports to the SEC of information necessary to keep registration statements current.[41] But these reports are relatively ineffective in providing the type of information needed to prevent this particular insider abuse, and, moreover, liability for violation of these provisions is limited to those persons makng or responsible for making false or misleading statements in the report.[42]

Disclosure of material information is a central theme of the securities legislation and undoubtedly will be emphasized in actions against insiders. But, while finding a duty to disclose makes unnecessary any discussion of scienter and reliance requirements under rule 10b-5, this duty is not so readily evident when privity does not

194 F. Supp. 207 (S.D.N.Y. 1961); Texas Continental Life Ins. Co. v. Bankers Bond Co., 187 F. Supp. 14 (W.D. Ky. 1960), *rev'd on other grounds sub nom.*, Texas Continental Life Ins. Co. v. Dunne, 307 F.2d 242 (6th Cir. 1962) (defendants distributed the bonds and knew of the defect causing their invalidity); Thiele v. Shields, 131 F. Supp. 416 (S.D.N.Y. 1955).

Perhaps the case involving a fact situation closest to that of the *Cochran* case was Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S.D.N.Y. 1951), *aff'd per curiam,* 198 F.2d 883 (2d Cir. 1952), in which the court stated that at least a semblance of privity was required. The court was roundly criticized in a dissent by Frank, J., and by 4 STAN. L. REV. 308 (1952), for incorporating into rule 10b-5 the restrictive common law notion that plaintiff must be one whom the defendant *actually* intended to defraud. But the court in the *Joseph* case suggested that the result might have been otherwise had plaintiff alleged reliance. Moreover, decisions by the same court in the *Cochran* case and *Brown v. Bullock, supra,* corroborate this suggestion.

[40] See, *e.g.*, In the Matter of Cady, Roberts & Co., SEC Securities Exchange Act Release No. 6668 (Nov. 8, 1961) (broker-dealer suspended for using non-public information of a dividend cut to aid clients prior to its being made public), 71 YALE L.J. 736 (1962); In the Matter of Ward La France Truck Corp., 13 S.E.C. 373 (1943) (corporation officers agreed to reimburse other shareholders from whom they had purchased stock with the intention of reselling at a previously confirmed higher price).

[41] Exchange Act § 13, 48 Stat. 894 (1934), 15 U.S.C. § 78m (1958).

[42] Section 13 of the Exchange Act specifies the information and the dates on which information must be reported. It does not broadly include all information which might be material, and it does not prevent the use of the information prior to reporting. Neither is there any provision for the dissemination of the information for use by the investing public. Any recovery for violation of § 13 would be under § 18, which contains limitations making recovery difficult. See note 33 *supra*.

exist. Thus, as in the *Cochran* case, mixed reliance upon a duty to disclose and upon evidence tending to show a scheme to defraud is justification for not requiring privity, even if part of the burden necessary to show such a scheme could not be sustained. However, where there is no evidence of active fraud in addition to non-disclosure, there appears no statutory or judicial justification for recovery without privity.