An Outsider Who Misappropriates Confidential Information My Be Charged with Securities Fraud: United States v. Newman

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AN OUTSIDER WHO MISAPPROPRIATES CONFIDENTIAL INFORMATION MAY BE CHARGED WITH SECURITIES FRAUD: UNITED STATES V. NEWMAN

Fraud in the securities market is a wide-spread contemporary problem.1 The roots of society's concern regarding securities fraud stem back to the period of the Great Depression.2 During the Depression, Congress enacted the Securities Exchange Act of 19343 (1934 Act) as a mechanism for regulating the sale and purchase of securities.4 Pursuant to section 10(b), a major anti-fraud provision of the 1934 Act,5 the Securities and Exchange Commission (SEC) promulgated rule 10b-5 to inhibit the incidence of fraud.6 Rule 10b-5


4. H.R. Rep. No. 1838, 73d Cong., 2d Sess. 32-33 (1934), reprinted in 5 J. Ellenger & E. Maher, Legislative History of the Securities Act of 1933 and the Securities Exchange Act of 1934, at Item 20 (Act regulates securities trading by banning the use of misleading statements for the purpose of inducing the purchasing or selling of securities, the sale or purchase for the purpose of fixing the price, and the disclosure of privileged information entrusted to specialists) [henceforth cited as Ellenger & Maher]; 78 Cong. Rec. 2264, 2271 (1934), reprinted in 4 Ellenger & Maher, supra, at Item 5 (Act regulates sale and purchase of securities, thereby insuring that the market will be completely open to investors and will curb past abuses by directors and officers by placing strict limitations on all trading practices). For a synopsis of each section of the Act see 78 Cong. Rec. 8160, 8164 (1934), reprinted in 4 Ellenger & Maher, supra, at Item 10.

   
   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 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.

prohibits affirmative misrepresentations or half-truths in connection with the purchase or sale of securities. This rule has become the primary tool by which the SEC combats fraudulent insider trading.

Generally, insider trading involves an individual who is privy to confidential business information by virtue of his position within a company. In the context of corporate acquisitions, the insider usually maintains a position with either the acquiring company or the company that is targeted for acquisition. Because the price of the target stock typically rises when news of the impending acquisition is disclosed, the insider often profits from his advance knowledge by purchasing stock of the target corporation while the price is low and selling the stock after publication of the acquisition has yielded an increase in its price. For decades, case law involving rule 10b-5 had been expanding liability to include more than this traditional characterization of the insider. That expansion was halted, however, when

7. Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1981), 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,
   (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.


Courts and commentators, however, have suggested a variety of persons who should be defined as an insider and, thus, subjected to liability. See, e.g., SEC v. Great Am. Indus., Inc., 407 F.2d 453 (2d Cir. 1968) (the corporation itself), cert. denied, 395 U.S. 920 (1969); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967) (agents for the insider), cert. denied, 390 U.S. 951 (1968); Poole, Corporate "Insiders" Face More Regulation, 48 Mich. St. B. J. 28 (1963) (investment bankers, management consultants). See also 2 A. Bromberg, Securities Law: Fraud § 7.46(b) (1982) (insider hard to define because meaning lies outside organization charts or other well-defined relationships).

10. It is argued that the United States Supreme Court is pursuing a retrenchment policy which seeks to limit the scope of § 10(b). See 5 Jacobs, supra note 8, § 7, at n.9.01. This trend is exemplified in several Supreme Court cases. See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976) (negligent conduct not within purview of § 10(b)); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731 (1975) (§ 10(b) private actions can only be brought by plaintiffs who are purchasers or sellers of stock). See also Note, Rule 10b-5 and Non-
the Supreme Court ruled that an individual who was not a member of either the acquiring or the target company had not committed securities fraud upon the sellers of stock when he traded based upon information misappropriated from another source.\textsuperscript{11} The Court left unresolved the issue of whether the information theft itself could be considered securities fraud.\textsuperscript{12}

This issue was squarely addressed by the Second Circuit Court of Appeals in \textit{United States v. Newman}.\textsuperscript{13} The defendant in \textit{Newman} held no position with either the acquiring or the target company and, thus, was not a traditional insider under rule 10b-5.\textsuperscript{14} Instead, the defendant gained access to the confidential corporate acquisition plans by his involvement in a conspiracy with an employee of an investment banking firm.\textsuperscript{15} Although the banking firm maintained only an advisory role in the impending securities transactions, the \textit{Newman} court held that the defendant's misappropriation of confidential information via the bank employee was a breach of fiduciary duty sufficient to uphold a criminal indictment for securities fraud.\textsuperscript{16}

The result in \textit{Newman} is laudable because to effectuate a major purpose of the 1834 Act—maintaining the integrity of the securities market\textsuperscript{17}—there must be an enforcement mechanism to prevent trading based on stolen information. Inadequacies in the \textit{Newman} court's method of analyzing traditional 10b-5 concepts, however, make it doubtful that the conclusion reached in this decision will withstand close scrutiny. The \textit{Newman} court's approach to securities fraud is not only unprecedented but also doctrinally distorted. Moreover, because the \textit{Newman} decision institutes a new theory of liability which is not expressly mandated by statute or legislative history, a constitutional argument exists that the defendant did not receive fair notice that his behavior was illegal.\textsuperscript{18}


12. \textit{See id.} at 236-37.


14. \textit{See supra} note 9 and accompanying text.

15. 664 F.2d at 15.

16. \textit{Id.} at 18.


Section 10(b) of the 1934 Act was enacted as part of a congressional scheme to eliminate fraudulent stock practices which were thought to have contributed to the stock market crash of 1929. This section broadly prohibits fraud by proscribing any manipulative or deceptive device utilized in connection with the purchase or sale of securities. Although the legislative history is scant, one principal legislative draftsman termed section 10(b) a catchall provision designed to prohibit "any cunning device" used to manipulate the market for personal gain. Courts and commentators have recognized that a major purpose of this section was to restore investor confidence in the securities market which was perceived as favoring insiders.

The prohibitions set forth in section 10(b) were given specific force when
the SEC, pursuant to its rule-making authority, promulgated rule 10b-5. Rule 10b-5 prohibits any person from making an untrue statement, engaging in any act, or employing any device that defrauds any person in connection with the purchase of securities. The major remedies established under the rule were developed in the context of SEC administrative proceedings and private damage actions. In addition, criminal sanctions for willful violations of rule 10b-5 are available under section 32(a), but rarely have been used. Courts initially relied on the common law fraud concept of deceit to

26. The SEC is empowered under 15 U.S.C. § 78w(a) (Supp. 1980), to create rules for the enforcement of § 10(b). See Hadsell v. Hoover, 484 F.2d 123, 126 (10th Cir. 1973) (rule 10b-5 was valid exercise of SEC's power); Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 786 (2d Cir. 1951) (dictum) (rule 10b-5 was validly promulgated by SEC pursuant to § 10(b)); United States v. Shindler, 173 F. Supp. 393, 394-95 (S.D.N.Y. 1959) (rule 10b-5 was valid exercise of SEC quasi-legislative powers); Note, The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors, 59 YALE L.J. 1120, 1139 (1950) (rule 10b-5 clearly within scope of SEC's power, no abuse of discretion).

27. 17 C.F.R. § 240.10b-5 (1981). For the text of this rule, see supra note 7.
28. See 15 U.S.C. § 78(v) (1976). The SEC had the authority to initiate its own investigations and to make and publish determinations regarding conduct it perceives to be in violation of the Act. Id. § 78(v)(a). Additionally, the SEC has the power to subpoena witnesses, id. § 78(v)(b), and seek injunctions in federal court to prevent continuing violations. Id. § 78(v)(d).
29. An implied private right of action was first recognized in Kardon v. National Gypsum Co., 69 F. Supp. 512, 513 (E.D. Pa. 1946). The Supreme Court acknowledged this right 25 years later. See Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971) ("[i]t is now established that a private right of action is implied under § 10(b)").

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. . . .

31. United States v. Chiarella, 588 F.2d 1358 (2d Cir. 1978) was the first case in which an outsider was prosecuted criminally for violating the anti-fraud provisions of rule 10b-5 by failing to disclose. To date there have been no other reported cases in which criminal liability was imposed for failure to disclose under rule 10b-5. Id. at 1373. For a discussion of the use of criminal sanctions under the Act, see generally A. Bromberg, Securities Law: Fraud § 10.3 (1982); Matthews, 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); Note, The Securities and Exchange Commission: An Introduction to the Enforcement of the Criminal Provisions of the Federal Securities Laws, 17 AM. CRIM. L. REV. 121, 121 n.9 (1979).
32. The common law tort of deceit requires proof of (1) a false representation; (2) knowledge or belief that the representation is false (scienter); (3) an intention to induce the plaintiff to act or to refrain from acting; (4) justifiable reliance by the plaintiff; and (5) damages based on such reliance. W. Prosser, Handbook of the Law of Torts § 105, at 685-86 (4th ed. 1971) [hereinafter cited as Prosser]. For a discussion of the early reliance of the courts on common law principles in interpreting rule 10b-5, see 5 JACOBS, supra note 8, §§ 2.10.03, 14.
interpret the meaning of securities fraud under rule 10b-5. The gravamen of the common law offense was that by misrepresenting a material fact, a party to a transaction took unfair advantage of the other party in the transaction.\textsuperscript{33} The infirmity of this common law approach was that it failed to recognize that mere silence or failure to disclose material facts also could deceive the other party.\textsuperscript{34} Despite this flaw, the common law fraud requirement of deceit between the parties to a transaction remained at the core of subsequent development of securities fraud.

Like the common law fraud concept of deceit, rule 10b-5 on its face imposes no penalty for mere silence.\textsuperscript{33} The courts, however, eventually began to realize that securities fraud often involved one party taking advantage of another by trading based on undisclosed information. Thus, to fulfill the regulatory intent of the 1934 Act, a need existed to go beyond the common

\textsuperscript{33} See, e.g., Alexander v. Church, 53 Conn. 561, 562, 4 A. 103, 104 (1886) ("Fraud consists in deception practiced in order to induce another to part with property or surrender some legal right, and which accomplishes the end desired") (quoting COOLEY, A TREATISE ON THE LAW OF TORTS OR THE WRONGS WHICH ARISE INDEPENDENTLY OF CONTRACT 474 (1880)). There was also a more elastic concept known as "equitable fraud" which did not require proof of deception. See Moore v. Crawford, 130 U.S. 120, 128 (1889) (fraud involves all acts, omissions, and concealments which are a breach of equitable duty, confidence, or trust that injure another); Patrick, Rule 10b-5, Equitable Fraud and Schoenbaum v. Firstbrook: Another Case in the Continuing Development of Federal Corporation Law, 21 ALA. L. REV. 457, 457 (1969) (a federal cause of action exists under rule 10b-5 when securities are purchased at an inadequate price by a stockbroker whether or not deception was involved).

34. The majority rule under common law was that an insider had no duty to disclose. See, e.g., Goodwin v. Agassiz, 283 Mass. 358, 361, 186 N.E. 659, 661 (1933) (director has no duty to disclose to stockholder). A minority of jurisdictions, however, found this rule too harsh and imposed a duty to disclose when the insider had a fiduciary relationship with the other party. See, e.g., Oliver v. Oliver, 118 Ga. 362, 367-68, 45 S.E. 232, 234 (1903) (director must disclose to stockholder if the information affects the selling price and the release will not hurt the company). Some jurisdictions adopted a third position which imposed a duty to disclose when the insider had special facts in his possession. See, e.g., Strong v. Repide, 213 U.S. 419, 431 (1909) (duty to disclose based on special knowledge of possible sale of company's assets). See also Comment, Insider Liability Under Securities Exchange Act Rule 10b-5: The Cady, Roberts Doctrine, 30 U. Chi. L. REV. 121, 123-24 (1962) (discussion of pre-10b-5 cases under the special facts rule). For a general discussion of the common law's gradual recognition of silence as fraud, see R. JENNINGS & H. MARSH, SECURITIES REGULATION 946 (4th ed. 1977); Fleischer, Mundheim & Murphy, An Initial Inquiry Into the Responsibility to Disclose Market Information, 121 U. PA. L. REV. 798, 802-03 (1973).

35. See supra note 7. Clause (b) of the rule refers to a failure to state material facts which are necessary to correct statements previously made. Thus, under a literal reading of the rule there is no liability imposed for total silence. See, e.g., Rogen v. Ilikon Corp., 250 F. Supp. 112, 116 n.5 (D. Mass.) (clause (b) does not appear to cover silence), rev'd on other grounds, 361 F.2d 260 (1st Cir. 1966); Trussell v. United Underwriters, Ltd., 228 F. Supp. 757, 767-68 (D. Colo. 1964) (clause (b) only applies when some statement already made); Cochran v. Channing Corp., 211 F. Supp. 239, 243 (S.D.N.Y. 1962) (clause (b) requires a statement to already have been made); Manne, Insider Trading and the Administrative Process, 35 GEO. WASH. L. REV. 473, 492-95 (1967) (corporate silence not covered by clause (b)); Comment, Rationalizing Liability for Nondisclosure Under 10b-5: Equal Access to Information and United States v. Chiarella, 1 WIS. L. REV. 162, 165 (1980) (no liability for absolute silence under 10b-5).
law and impose a duty to disclose. Under such an approach, a failure to disclose material information in the course of a securities transaction constitutes a breach of duty and, thus, securities fraud. Under this approach, insider trading is clearly securities fraud because such activity is predicated upon one party's failure to disclose material information to another.

The scope of activities encompassed by insider trading has undergone considerable expansion. The duty to disclose was first applied to corporate officers and directors. In *Kardon v. National Gypsum*, corporate officers committed a 10b-5 violation when they bought out shareholders without disclosing that a substantially higher price was available from an acquiring corporation. The duty breached by the corporate officials was premised on their fiduciary relationship with the shareholders.

Subsequently, the duty to disclose was extended from traditional insiders, such as corporate officers, to "tippees," individuals who received information from insiders. In *In re Cady, Roberts & Co.*, the SEC found an investment broker guilty of fraud under rule 10b-5 when he traded based on confidential information acquired from a director of the issuing corporation. The *Cady, Roberts* court based the broker's duty to disclose on two factors:

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36. The courts have been willing to interpret rule 10b-5 as requiring such a duty. See Arber v. Essex Wire Corp., 490 F.2d 414, 418 (6th Cir. 1974) (rule 10b-5 is necessarily a disclosure rule); Abramson v. Nytronics, Inc., 312 F. Supp. 519, 526 (S.D.N.Y. 1970) (10b-5 is "basically a disclosure provision"). See also Speed v. Transamerica Corp., 99 F. Supp. 808, 843 (D. Del. 1951) (controlling shareholder who buys minority shareholder had duty to disclose both greatly appreciated inventory value and plan to sell corporation in order to capture that appreciation). For a discussion of the justification for finding disclosure as an underlying policy of rule 10b-5, see generally 5 Jacobs supra note 8, § 6.05.

37. "One of the primary purposes of the Securities Exchange Act ... was to outlaw the use of inside information by corporate officers and principal stockholders for their own financial advantage to the detriment of uniformed public security holders." Speed v. Transamerica Corp., 99 F. Supp. 803, 819 (D. Del. 1951). See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 235 (2d Cir. 1974) (Act designed to promote fair dealing by requiring full disclosure of inside information); Radiation Dynamic, Inc. v. Goldmuntz, 464 F.2d 876, 890 (2d Cir. 1972) (purpose of Act is to preclude insiders from taking unfair advantage of investors without equal access to information).


40. Id. at 802.

41. A fiduciary relation exists in the broadest sense whenever one trusts or relies upon another. See Prosser, supra note 32, § 106, at 697. According to Prosser, examples of fiduciary relationships that have required disclosure include: principal and agent, executor and beneficiary of an estate, bank and investing depositor, majority and minority stockholders, old friends, attorney and client, physician and patient, priest and parishioner, partners, tenants in common, husband and wife, parent and child, guardian and ward, as well as types of contracts such as suretyship, guaranty, insurance, and joint venture. Id.

42. 40 S.E.C. 907 (1961).

43. Id. at 912.
(1) the inherent unfairness of taking advantage of nonpublic information, and (2) the broker's special relationship with the company. The decision focused mainly on the director's fiduciary relationship to his corporation. The SEC concluded that the director's relationship, with its concommitant duty to disclose, could not be avoided merely because the director did not trade himself. Analyzing the duty as vicarious, the SEC reasoned that because the director's fiduciary relation gave rise to a duty not to trade, this same duty passed with his tip, and thus, the broker-tippee also was prohibited from trading.

Subsequently, in SEC v. Texas Gulf Sulphur, the focus of the analysis shifted from concern with corporate relationships to considerations of fairness. The officers and employees of Texas Gulf Sulphur Corporation committed securities fraud by purchasing shares of the corporation's stock without disclosing their knowledge of a valuable corporate mineral discovery. The Second Circuit, looking exclusively at the fairness element of Cady, Roberts, stated the essence of rule 10b-5:

[A]nnyone who, trading for his own account in the securities of a corporation, has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take advantage of such information knowing it is unavailable to those with whom he is dealing.

Because all the defendants in Texas Gulf maintained a fiduciary relationship to the company, the court could have based the duty to disclose on those relationships. Instead, in dicta, the court framed a broad disclosure rule stating that: "anyone in possesson of material inside information must either disclose it to the investing public or... refrain from trading..." Such a broad rule, when applied in the context of corporate acquisition plans, would prohibit trading on the basis of confidential information even by outsiders who maintained no relationship with either the acquiring or target corporation.

44. Id. One commentator found Cady, Roberts to be seminal because it clearly established that nondisclosure was fraud under rule 10b-5 and that the rule could reach nondisclosure by persons who would not be defined as insiders under common law or by the terms of other sections of the Exchange Act. Comment, Insider Liability Under Securities Exchange Act Rule 10b-5: The Cady, Roberts Doctrine, 30 U. CHI. L. REV. 121, 122 (1962). See also 6 L. Loss, SECURITIES REGULATION, 3561 (2d ed. 1961) (contract with close relation of an insider is treated like a contract with the insider himself).

45. 40 S.E.C. at 912.
46. 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).
47. Id. at 852.
48. Id. at 848 (citing In re Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961)).
51. 401 F.2d at 833.
It is important to note that even under the *Texas Gulf* court's broad interpretation of rule 10b-5, the rule only proscribes fraud that occurs in the relationship between buyers and sellers. Therefore, in accordance with the common law approach, fraud under the *Texas Gulf* rule exists when one party to a transaction uses deceit to profit at the expense of the other party.

Courts have been reluctant to extend liability for nondisclosure to outsiders except in cases of exceptional unfairness. This reluctance was exemplified in *Chiarella v. United States*. Chiarella was a printer who worked for a firm that prepared the paperwork involved in corporate acquisitions. Through his work he obtained confidential information regarding impending corporate acquisitions, and used the information to buy stock of the target companies at a relatively low price. Once the information became public and the securities rose in price, he was able to sell the securities for a substantial profit. The Second Circuit acknowledged that Chiarella was not affiliated with either the acquiring corporation or the target corporation and, thus, owed no fiduciary duty to either entity. Absent such a fiduciary relationship, the court held that Chiarella's conduct could not subject him to civil liability for securities fraud based on breach of the duty to disclose. Nevertheless, the Second Circuit found Chiarella criminally liable for securities fraud because he was a "market insider", a person with regular access to confidential market information. As such, he owed a duty to disclose the information or refrain from trading on the market as a whole. The Supreme Court reversed the finding of criminal liability reasoning that although silence could operate as a fraud in some instances, a duty to speak must be premised on a fiduciary relationship. Because Chiarella had no previous relationship with those who sold him stock, he had no duty to disclose the confidential information. The Court rejected the theory that market insiders owe a duty to the entire market reasoning that such a duty could not be implied from either the legislative history or the explicit language of section 10(b).

Furthermore, because the question of liability based on the defen-

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52. *See, e.g.*, Frigitemp v. Financial Dynamics Fund, 524 F.2d 275, 282 (2d Cir. 1975) (no 10b-5 claim because corporate outsiders have no duty to disclose); General Time v. Talley Indus., Inc., 403 F.2d 159, 164 (2d Cir. 1968) (company making a tender offer was under no duty to disclose its intentions to target company), *cert. denied*, 393 U.S. 1026 (1969).

53. *See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128, 153 (1972) (bankers who were neither insiders nor tippees held liable due to trust reposed in them); Zweig v. Hearst Corp., 594 F.2d 1261, 1271 (9th Cir. 1979) (financial columnist liable for fraudulent nondisclosure based on the relationship of trust with his readers when he bought stock in anticipation that his published recommendations would cause its price to rise); Crane v. Westinghouse Air Brake Co., 419 F.2d 787, 796 (2d Cir. 1969) (duty to disclose when tender offeror acts in concert with target management), *cert. denied*, 400 U.S. 822 (1972).


56. *Id.* at 1364.

57. *Id.* at 1365.


59. *Id.* at 224.

60. *Id.* at 233. "We cannot affirm petitioner's conviction without recognizing a general duty between all participants in a market transaction to forgo [sic] actions based on material,
nant's breach of duty to his own employer had not been properly presented to the jury, the Court refused to speculate on this issue. Two years after Chiarella, however, in United States v. Newman, the Second Circuit faced this precise question.

**FACTS AND PROCEDURAL HISTORY**

John Newman, a securities trader, allegedly received secret "market information" concerning corporate acquisition plans. This information had been misappropriated from the investment banking firms of Morgan Stanley and Kuhn Loeb. The information was passed on to Newman by employees of these firms who were involved in assisting corporate clients in the elaborate preparations incident to mergers, tender offers, and takeover bids. Newman passed the acquisition information to two confederates who purchased stock in the target companies. After the proposed plans were revealed to the public and the price of the target securities increased, the conspirators sold their shares for a substantial profit.

Newman was indicted and charged with securities fraud under section 10(b) and rule 10b-5 of the 1934 Act, mail fraud, and conspiracy to commit securities and mail fraud. The district court dismissed the securities fraud charge because it could find no clear prohibition in the federal securities laws putting Newman on notice that his conduct was criminal. The Second Circuit Court of Appeals reversed, however, reasoning that by proscribing fraudulent and deceptive practices, rule 10b-5 gave Newman clear notice that his conduct was unlawful. The majority held that Newman could be


61. 445 U.S. at 236-37.
63. "Market information" is information concerning events or circumstances which affect the market for a company's securities but which do not affect the company's assets or earning power. An Initial Inquiry, supra note 60, at 799.
64. 664 F.2d at 15. The plans included mergers, tender offers, and takeover bids. The plans were secret because knowledge of the impending acquisition would tend to increase the value of the stock of the corporation to be acquired (the target corporation). An unscrupulous individual who knew the secret could buy the stock at the low market price and then resell at the higher price after the acquisition plans became public knowledge. Id.
65. Id.
66. See 18 U.S.C. § 1341 (1976) (proscribes any use of the mail for the purpose of executing specified unlawful scheme or artifice to defraud).
67. See 18 U.S.C. § 371 (1976) (proscribes conspiracy to defraud or commit any offense against the U.S.). The scope of this Note is limited, however, to the securities fraud issue.
70. Judge Von Graefeland wrote the opinion, joined by Judge Newman. The third member of the panel, Judge Dumbould concurred in the reversal of the district court solely on the
charged with fraud within the meaning of the 1934 Act because his participation in the theft of confidential information was a breach of the fiduciary duty he owed to the investment bankers and to the bankers' corporate clients. 72

**THE NEWMAN OPINION**

The Second Circuit began its analysis with a review of its decision in *Chiarella* and the subsequent reversal of that decision by the Supreme Court. 73 The indictment in *Newman* was structured, explained the court, to meet the deficiencies in *Chiarella*. Instead of charging that fraud had been perpetrated upon the sellers of the securities, the theory rejected by the *Chiarella* Court, the *Newman* indictment charged that fraud had been committed upon the intermediate employer, Morgan Stanley. 74 An impediment to the *Newman* court's theory, however, arose from the fact that the language of section 10(b) prohibits fraud only "in connection with the purchase or sale of any security." 75 There was no sale or purchase between Newman or his co-conspirators and Morgan Stanley.

In addressing this problem, the court interpreted the "in connection with the purchase or sale" language of rule 10b-5 as constituting a limitation only with respect to which parties have standing to sue. 76 The court pointed out that the statute did not expressly grant private plaintiffs a right to sue. The private right to sue was judicially created, as was the limitation of that mail fraud charges. Judge Dumbould did not agree that the deceptive practices alleged against Newman were securities fraud because they were not "in connection with the purchase or sale of any security." *Id.* at 20 (Dumbould, J., concurring) (citing § 10(b)).

71. John Newman was the only defendant before the court. *Id.* at 15. Because Newman was charged with conspiring with E. Jacques Courtois, an employee of Morgan Stanley who fled the country, he could be held responsible under conspiracy law for any actions committed by his fellow conspirators. *Id.* at 20. Thus, in analyzing the case, Newman may be regarded as an employee of Morgan Stanley. See United States v. Courtois, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,024, 91,290 (S.D.N.Y. June 5, 1981) (Newman has the same fiduciary duties as Courtois).

72. 664 F.2d at 17.

73. See 588 F.2d 1358 (2d Cir. 1978), rev'd, 445 U.S. 222 (1980). See also supra notes 54-62 and accompanying text.

74. 664 F.2d at 15 ("the Government here has pointed its charge of wrongdoing in a different direction").

75. See supra note 5. The "in connection with the purchase or sale of any security" language is repeated in rule 10b-5. See supra note 7. The Supreme Court has held that rule 10b-5 can have no wider scope than § 10(b) under which it was promulgated. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197, 213-14 (1976). See also SEC v. Coven, 581 F.2d 1020, 1026 (2d Cir. 1978) (breadth of rule can be no greater than the statutory provision), cert. denied, 440 U.S. 950 (1979); Note, SEC Rule 10b-5: A Recent Profile, 13 WM. & MARY L. REV. 860, 870 (1972) (rule must be within the bounds of its enabling statute).

76. 664 F.2d at 17. In support of this interpretation the court cited Blue Chip Stamps v. Manor Drug Stores, 421 U.S 723 (1975). The *Blue Chip* Court stated that "one asserting a claim for damages based on the violation of Rule 10b-5 must be either a purchaser or seller of securities." *Id.* at 749.
right to include only plaintiffs who were purchasers or sellers of securities. The court concluded, however, that criminal sanctions are expressly permitted under the statute and, therefore, are not subject to judicial limitations. Thus, according to the *Newman* court, standing was an irrelevant issue because *Newman* involved a criminal indictment brought by the federal government.

The court addressed the meaning of the "in connection with the purchase or sale" language a second time when it refuted Newman’s contention that even if his conduct was fraudulent, it had no connection with the purchase or sale of securities. The court found little merit in this argument because, in its view, the *Newman* conspirators’ sole purpose in misappropriating the information was to purchase securities.

Focusing next on the major issue left unanswered by *Chiarella*, the *Newman* court questioned whether the defendant’s participation in the misappropriation of information from Morgan Stanley and the subsequent use of that information in securities transactions was a fraud upon Morgan Stanley and Morgan Stanley’s clients. The court summarily analyzed the fraud issue, and characterized Newman’s conduct as theft. According to the court, if Newman had used similar deceitful practices to steal cash or securities directly from Morgan Stanley, his actions would be characterized as fraud. Thus, the court concluded that Newman’s theft of information was fraud. The court further maintained that the firm’s loss of its reputation for confidentiality was as significant as the loss of money. Therefore, the majority concluded that Newman could be indicted for securities fraud. To buttress this conclusion, the court pointed out that in other areas of the law, theft of confidential information, albeit not always described as fraud, consistently has been held to be unlawful. The court was persuaded that Congress must

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77. 664 F.2d at 17. The first case to limit standing to sue to either purchasers or sellers of securities was Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2d. Cir.), cert. denied, 343 U.S. 956 (1952). The Birnbaum holding has been cited for this proposition in a large number of cases. For a listing of these cases, see S. Jacobs, supra note 8, § 38.01[d]. This limitation on standing to sue was adopted to prevent a flood of litigation which the courts feared would result if plaintiffs who had neither purchased nor sold securities could bring an action based merely on speculative damages. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739 (1975). See also Bound Brook Water Co. v. Jaffe, 284 F. Supp. 702, 708 (D.N.J. 1968) (flood of litigation would result from more expansive view of standing requirement).

78. 664 F.2d at 17.

79. Id. at 18. The court viewed the connection between Newman’s supposed fraud and the purchase of securities as within the standard of Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12-13 (1971) (“in connection with” should be flexibly interpreted to include deceptive practices “touching” the sale of securities). One commentator, however, has noted that this case may have been set adrift into oblivion in light of the Court’s retrenchment policy. See W. Cary & M. Eisenberg, Cases and Materials on Corporations 795 (5th ed. 1980).

80. “[W]e need spend little time on the issue of fraud or deceit.” 664 F.2d at 17.

81. Id. Chief Justice Burger had applied the term theft to similar conduct by the defendant in *Chiarella* v. United States, 445 U.S. 222, 245 (1980) (Burger, C.J., dissenting).

82. 664 F.2d at 17.

83. Id. at 18. The court relied on several federal appeals court’s decisions. See United States v. Kent, 608 F.2d 542 (5th Cir. 1979) (fraud to steal oil company’s maps and well completion
have intended an equally rigorous code of conduct under the Securities Acts.\textsuperscript{84}

**ANALYSIS OF THE OPINION**

As a matter of public policy, the result in *Newman* is commendable. Only the staunchest defenders of insider trading could find anything socially useful in Newman's scheme.\textsuperscript{83} Indeed, imposition of liability under the factual scenario in *Newman* conforms to the original aim of the 1934 Act—protecting the integrity of the securities market.\textsuperscript{86} Additionally, the threat of criminal penalties for securities fraud may serve as a deterrent for employees in positions similar to Newman's. In attempting to distinguish *Chiarella*, however, the Second Circuit pronounced a new theory of fraud which is subject to serious doctrinal, statutory, and constitutional questions.

Doctrinally, the *Newman* court distorts the usual concept of fraud. In all its many varieties,\textsuperscript{87} legal fraud basically involves a transaction in which one party, through misrepresentation or through deceitful silence, reaps a pecuniary reward from the other party to the transaction.\textsuperscript{88} In *Newman*, however, the supposed victims, Morgan Stanley and its clients, were not the direct source of Newman's unlawful gain. Although Morgan Stanley and its clients might have suffered some intangible loss through Newman's breach of confidentiality,\textsuperscript{89} the individuals who sold the stock to Newman's co-conspirators prior to public disclosure of the corporate acquisition plans were

reports), *cert. denied*, 446 U.S. 936 (1980); United States v. Girard, 601 F.2d 69 (2d Cir.) (theft and sale of government information was fraud), *cert. denied*, 444 U.S. 871 (1979); Abbott v. United States, 239 F.2d 310 (5th Cir. 1956) (theft of maps reflecting geophysical information where there was prearrangement for their purchase and use to the detriment of the owner company); United States v. Buckner, 108 F.2d 921 (2d Cir.) (conversion of bondholders' money to private use was fraud), *cert. denied*, 304 U.S. 669 (1940).

84. 664 F.2d at 18 (purpose of the 1934 Act is not only the prevention of fraud against investors, but also to seek high standards of business ethics in every facet of the securities industry) (citing United States v. Naftalin, 441 U.S. 768, 774-76 (1979)).


86. See H.R. REP. No. 1383, 73d Cong., 2d Sess. 5, 13 (1934) (need for new law to restore investor confidence). The concern by Congress of the need to restore investor confidence which had been shaken by the 1929 stock market crash was evident during congressional hearings on the 1934 Act. See Brudney, *supra* note 25.

87. It has been said of fraud that "age cannot wither, nor custom stale her infinite variety." *In re Cady*, Roberts & Co., 40 S.E.C. 907, 911 n.12 (1961).

88. See *supra* note 33 and accompanying text. See also Keeton, *Fraud—Concealment and Non-Disclosure*, 15 TEX. L. REV. 1 (1936) (fraud consists of misrepresentation by direct statement, conduct, or silence).

the actual sources of Newman's profits. Nonetheless, the *Newman* court distorted the traditional concept of fraud and found a criminal violation under the securities law because the defendant deceived Morgan Stanley, but reaped a pecuniary reward from shareholders of the target corporation who were not themselves defrauded under rule 10b-5.

This distortion becomes even more apparent when Newman’s misconduct is evaluated with respect to the language of section 10(b) and rule 10b-5. The operative statutory language in both the section and the rule prohibits fraud "in connection with the purchase or sale of any security." This language has been recognized as serving three primary functions: (1) to establish the class of plaintiffs who have standing to sue; (2) to establish the class of plaintiffs who are protected by the 1934 Act; and (3) to define the substantive limitations of section 10(b) and rule 10b-5. Thus, when the *Newman* court concluded that rule 10b-5 should be applied in the instant case because there was no standing problem, its conclusion was inadequate because it failed to examine whether Newman’s conduct was within the substantive statutory limitations imposed under the “in connection with” language of section 10(b) and rule 10b-5.

The view that the “in connection with” language is a substantive as well as procedural limitation under the 1934 Act is compelled by logic and case law. Conduct which falls outside of that explicitly proscribed by section 10(b) is not securities fraud. Therefore, logic suggests that the statutory language must be accorded a broader significance than merely defining the persons who have standing to sue. The cases interpreting the “in connection with” language of rule 10b-5 have, for the most part, focused on the limited context of standing to sue in private damage actions. However, the focus of these cases has been limited to this procedural analysis, courts have not been required to address the substantive limitations of rule 10b-5. In *Birnbaum v. Newport Steel Co.*, however, the first case to limit standing to private plaintiffs who are either purchasers or sellers, the court did briefly discuss the broader question of substantive limitations. Similarly, the *Texas Gulf* court referred to the substantive limitations of section 10(b) when it explained that Congress only intended to prohibit the fraudulent or deceptive schemes

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91. 5 JACOBS, supra note 8, § 38.01[a].
93. See Ketchum v. Green, 557 F.2d 1022, 1025 (3d Cir.), cert. denied, 434 U.S. 940 (1977); 5 JACOBS, supra note 8, §§ 38-40.
94. The *Newman* court referred to the history of the standing requirement but did not draw this same logical inference. See 664 F.2d at 16 (1981).
96. The *Birnbaum* court looked beyond standing to the scope of the rule in the context of the underlying statutory scheme. The court concluded that the rule had no relation to breaches of fiduciary duty by corporate insiders which resulted in fraud upon those who were not purchasers or sellers. 193 F.2d at 463.
that investors might rely upon in connection with the sale or purchase of securities.97

Arguably, if the Second Circuit had proceeded to this substantive analysis it would have concluded that the conduct in *Newman* fell beyond the pur-view of section 10(b) and rule 10b-5. Specifically, because Newman and his co-conspirators did not maintain a fiduciary relationship with the shareholders from whom the stock was purchased, nor engage in securities transactions with either Morgan Stanley or its clients, the substantive limitations applied. By refusing to proceed with such an analysis, the *Newman* court failed to recognize the warning of the Supreme Court that not every breach of fiduciary duty can be brought within the ambit of rule 10b-5.98 Instead, the court found a rule 10b-5 violation by focusing on a fiduciary relationship which clearly was beyond the substantive limitations of the rule. This unprecedented focus produced a paradoxical result which can best be illustrated by comparing the Second Circuit's decisions in *Newman* and *Chiarella*. The *Newman* court correctly observed that the defendant had engaged in exactly the same activities as the defendant had in *Chiarella*.99 In each case, the defendant stole information which, if made public, would have raised the price of certain securities. In each case, the defendant or his conspirators purchased those stocks without disclosing the information. Silence was essential to the success of both schemes because the defendants' profits depended on buying the securities before the news of the impending corporate acquisitions became public. The court in *Chiarella* viewed the defendant's fraudulent actions as silence.100 The *Newman* court, on the other hand, viewed the defendant's fraudulent action as disclosing information to his co-conspirators concerning the impending acquisition, thereby, failing to be silent.101 It seems wholly inconsistent for the Second Circuit, on essentially the same facts, to find Newman guilty because he failed to be silent. In fact, John Newman was equally as silent as Vincent Chiarella because the success of his scheme depended on it. Yet in both instances, the Second Circuit found a rule 10b-5 violation.

Although this distinction is seemingly untenable, the result in each case can be attributed to the court's divergent methods of analysis. In *Chiarella*, the Second Circuit concluded that the defendant owed a duty to the trading public in general, and thus, breached that duty by failing to disclose insider

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98. See, e.g., Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977) (corporate mismanagement is not fraud under rule 10b-5). *Accord* AMERICAN LAW INSTITUTE, FEDERAL SECURITIES CODE § 1603 comment 3(b) ("fraud still requires something more than unfairness or breach of fiduciary duty").
99. 644 F.2d at 17.
100. 588 F.2d 1358, 1364-66 (2d Cir. 1978). The Supreme Court also characterized Chiarella's actions as silence. "This case concerns the legal effect of the petitioner's silence." *Chiarella v. United States*, 445 U.S. 222, 223 (1980). The Supreme Court, however, did not conclude that Chiarella's silence was securities fraud. *See supra* notes 58-61 and accompanying text.
101. 664 F.2d 12, 16 (2d Cir. 1981).
information. 102 The Supreme Court, in its subsequent reversal of this decision, ruled that no fiduciary duty exists to the general public, and as such, absent any fiduciary duty, Chiarella's silence could not be deemed fraud under rule 10b-5. 103

Faced with the Supreme Court's decision in Chiarella, the Second Circuit in Newman undoubtedly sought to identify a fiduciary relationship which would permit it to hold the defendant liable for securities fraud under a factual situation similar to that in Chiarella. Thus, the Newman court focused on the only fiduciary relationship existing in Newman—the employer/employee relationship between Morgan Stanley and Newman—and imposed a duty of silence thereunder. 104 While it is undoubtedly true that Newman and his fellow conspirators breached a duty of loyalty to Morgan Stanley, such employee misconduct should not amount to securities fraud. Because Morgan Stanley was not connected with the transaction in a manner prescribed by rule 10b-5, 105 Newman's breach of loyalty could not operate as securities fraud under section 10(b) and rule 10b-5. The Newman court's expansive interpretation of section 10(b) and rule 10b-5 has added a gloss to the statute which goes beyond its commonly accepted meaning. 106 Moreover, the court had disregarded the Supreme Court's mandate that although rule 10b-5 is an elastic catch-all, what it catches must be fraud. 107

The message being conveyed by the Second Circuit is clear—anyone with insider information must refrain from trading until this information is publicly disclosed. Although such a protective mandate is commendable, the court's convoluted analysis has created an unprecedented expansion of rule 10b-5. By doing so, the Second Circuit's desire to protect the public manifests a result oriented approach which disregards the substantive limitations of the Securities Act.

A further criticism of the Newman decision stems from the court's decision to embrace a novel theory of securities fraud which has wide ranging implications beyond the problems of doctrinal distortion and statutory interpretation. Whether phrased in terms of lack of notice or due process, the theory advanced by the Newman court is constitutionally unsound. The Supreme Court has observed that, "no one may be required at peril of life, liberty or property to speculate as to the meaning of penal statutes." 108 Yet, it is ludicrous to expect that the defendant in Newman had clear notice that his conduct was criminal under rule 10b-5 before the decision in Newman was

102. 588 F.2d 1358, 1365 (2d Cir. 1978).
104. The court cited to the indictment which charged the defendant with a violation of the fiduciary duties of honesty, loyalty, and silence. 664 F.2d at 16.
105. See supra notes 90-98 and accompanying text.
106. The Supreme Court previously criticized the SEC for adding a gloss to the statute in Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976) (cannot read negligence into the statute).
In addition to the lack of notice in the statutory language and the judicial precedent previously discussed, other possible sources of notice are equally ambiguous. The SEC itself has been unclear about how to regulate non-insider trading based upon advance knowledge of a tender offer. Nor can notice be found in SEC enforcement actions against defendants essentially in Newman's position. Such actions have generally ended in consent decrees rather than full blown litigation. Thus, although the consent decrees may give notice of the SEC's displeasure with Newman-like behavior, they do not constitute precedent sufficient to establish fair notice of possible criminal sanctions.

Finally, while Newman, as a sophisticated market professional, may have realized his conduct was ethically questionable, such knowledge does not serve as notice of a criminal violation of the securities laws. The Supreme Court has maintained that the scope of a criminal statute must be determined by


110. The Supreme Court expressed concern about the lack of notice in Chiarella, 445 U.S. at 235 n.20. The Court cited to Grayned v. City of Rockford, 408 U.S. 104 (1972), where it had stated that a law must be clear enough to provide a person of ordinary intelligence the opportunity to know what is prohibited. Id. at 108. See also Dunn v. United States, 442 U.S. 100, 112-13 (1979) (boundaries of criminal conduct must be marked with special clarity); Connally v. General Constr. Co., 269 U.S. 385, 391 (1926) (due process is violated when terms of statute must be guessed at by those of ordinary intelligence); United States v. Chiarella, 588 F.2d 1358, 1376-78 (Meskill, J., dissenting) (notice as to what is forbidden must emanate from language of statute); United States v. Courtois, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,024 (S.D.N.Y. June 5, 1981) (Newman did not have sufficient notice). But see United States v. Charnay, 537 F.2d 341, 356 (9th Cir.) (Sneed, J., concurring) ("in fixing criminal liability under section 10(b) and rule 10b-5, we attach reduced importance to assertions of vagueness").

111. The SEC had engaged in a 10 year debate with securities professionals over the practice of "warehousing," a scheme whereby a tender offeror gives large institutional investors notice of its plans so that they can purchase target stock before there is a price rise. The practice has some similarities to the conduct in Newman. The district court, after reviewing the history of the debate, concluded that no clear understanding of the law existed from which Newman could have been put on notice. See United States States v. Courtois, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶¶ 98,024, 91,292 (S.D.N.Y. June 5, 1981) (reviews the history of tender offer regulation and concludes that confused state of the law deprived Newman of notice).


113. Lipsky v. Commonwealth United Corp., 551 F.2d 887, 893-94 (2d Cir. 1976) (consent decree against defendant cannot be included in support of private plaintiff's complaint).
Newman's subjective views about his conduct could not transform his actions, no matter how egregious, into conduct criminal under rule 10b-5.

**Alternatives**

Although Newman's actions do not violate rule 10b-5, there are other mechanisms that could be implemented to prohibit conduct similar to Newman's. One such mechanism is rule 14e-3 which was recently promulgated under section 14(e) of the 1934 Act. Rule 14e-3 provides that once a tender offer is substantially under way, no one possessing material information about the offer may trade in the security without disclosing that information to the public. Although the rule is yet untested, it clearly obviates several of the glaring deficiencies in Newman. Because the rule specifically prohibits anyone with inside information from trading, there is no need to distinguish insiders from outsiders or to identify a fiduciary relationship. The clarity of the rule eliminates the lack of notice which marred Newman. Such an approach may find favor when conduct similar to Newman's confronts the Supreme Court. Indeed, the use of a clear rule should be appealing to the Court because of the Court's distinct preference for restricting the scope of securities laws to their plain language.

Alternatively, the contorted analysis utilized by the Newman court to invoke the provisions of rule 10b-5 could be avoided by employing state agency principles. Agency law, as summed-up in the *Restatement (Second) of Agency*


115. 17 C.F.R. § 240.14e-3 (1981), provides:

If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

1. The offering person, 
2. The issuer of the securities sought or to be sought by such tender offer, or 
3. Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities . . . unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.


117. See supra note 115.

118. See Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977) (scope of a rule cannot be construed more broadly than the language of the statute).

119. The Supreme Court has recognized the propriety of preserving and employing state law concepts where appropriate in the securities context. "[W]e are reluctant to federalize the substan-
cy, provides that an agent is under a duty to his principal not to disclose confidential information acquired [from the principal] in the course of his agency.\textsuperscript{120} Newman's misappropriation of information from Morgan Stanley could be seen as a violation of this agency principle. Clearly, there was an alternative available upon which the Second Circuit could have relied to find Newman's conduct culpable without broadly interpreting section 10(b) and rule 10b-5.

CONCLUSION

In Newman v. United States, the Second Circuit confronted a securities fraud issue that had not been expressly addressed by the Supreme Court. The court determined that an outsider who owes no fiduciary duty to either the acquiring or target corporation involved in a tender offer may be charged with criminal securities fraud when he misappropriates nonpublic information regarding that tender offer from a company to which he owes a fiduciary duty.

Newman is commendable for its attempt to provide an enforcement mechanism against acts which threaten to undermine investor confidence in the securities market. The decision is flawed, however, by its novel and distorted theory of securities fraud. The novelty of the theory has the additional defect of depriving the defendant of notice concerning the possible illegality of his activity. Further, by not thoroughly analyzing the language of the 1934 Act, Newman brings within the ambit of rule 10b-5 conduct which could be adequately regulated by state agency law.

Michael J. Falconer

\textsuperscript{120} RESTATEMENT (SECOND) OF AGENCY § 395 (1958).

\textsuperscript{120} Id. at 479.