Pace Law Review

Volume 3
Issue 2 *Winter 1983*

Article 5

January 1983

United States v. Newman: Misappropriation of Market Information by Outsiders

James M. Robertson

Recommended Citation

James M. Robertson, *United States v. Newman: Misappropriation of Market Information by Outsiders* , 3 Pace L. Rev. 311 (1983)

DOI: https://doi.org/10.58948/2331-3528.1640

Available at: https://digitalcommons.pace.edu/plr/vol3/iss2/5

United States v. Newman: Misappropriation of Market Information by Outsiders

I. Introduction

In *United States* v. *Newman*,[1] the majority of a three-judge panel held that an outsider[2] who trades securities based upon material nonpublic market information[3] that is misappropriated from someone with whom he had a relationship of trust and confidence violates section 10(b) of the Securities Exchange Act,[4]

---

1. 664 F.2d 12 (2d Cir. 1981), *rev'g* United States v. Courtois, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,024 (S.D.N.Y. June 5, 1981).

2. Outsiders, as opposed to insiders, *see infra* note 52, and tippees, *see infra* note 60, have no connections whatsoever to the company whose stock they are trading in.

3. Market information refers to events occuring outside a company, such as a tender offer, which will have an effect on the price of its securities. *See* Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 329-30 (1979); Fleischer, *Mundheim & Murphy, An Initial Inquiry Into the Responsibility To Disclose Market Information*, 121 U. PA. L. REV. 798, 799 (1973). Inside information, on the other hand, emanates from within the company and concerns facts about its assets and earning power, such as a new research breakthrough or resource discovery. *Id.*

4. Section 10(b) provides in relevant part:

> It shall be unlawful for any person directly or indirectly, by use of any means or instrumentality of interstate commerce or 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 proscribe as necessary or appropriate in the public interest or for the protection of investors.

Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1976). Since the language of section 10(b) was not self-effectuating, but required Securities and Exchange Commission (SEC) rules to enforce it, Rule 10b-5 was promulgated, which provides:

> It shall be unlawful for any person, directly or indirectly, by 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 light of the circumstances under which they were made, not misleading, or

even though the fraud was not against a purchaser or seller.[5] Liability for outsider trading had been addressed by the Supreme Court one year earlier in *Chiarella* v. *United States*.[6] That case held that an outsider had no duty to disclose his informational advantage to an ordinary seller in the marketplace because there was no fiduciary relationship between the parties that would create a duty to speak.[7] The Court, however, failed to rule on the government's alternative theory, which based liability upon the defendant's fraudulent misappropriation of material nonpublic information from his employer and its clients.[8] It is this theory that was approved in the *Newman* decision[9] and its importance lies in the fact that it now provides the government with a means to control abusive trading practices by outsiders.

The fraud in *Newman* stems from the activities of employees of two investment banking firms which plan takeover bids for offering companies.[10] According to the government, the employees surreptitiously passed confidential information about the identities of the "target" companies desired by the offerors to accomplices outside their firms. One of these coconspirators was James Mitchell Newman, who was in charge of over the counter trading at another firm. Together with two European cohorts, Newman bought securities in the proposed "targets" and sold them at a profit when the merger plans were made public. The proceeds were then split with the employees who supplied the information. To avoid discovery of their activities, the transactions were made using, among other devices, offshore

---

> (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 (1982). For a comprehensive review of the law that has developed under section 10(b) and Rule 10b-5, *see generally* A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD (1982); A. JACOBS, THE IMPACT OF RULE 10B-5 (1980).

5. United States v. Newman, 664 F.2d at 16.

6. 445 U.S. 222 (1980). *See infra* notes 97-134 and accompanying text.

7. *Id.* at 235.

8. *Id.* at 235-36. The Court found that this argument was not presented squarely to the jury. *Id.* at 236. *See infra* notes 123-24 and accompanying text.

9. United States v. Newman, 664 F.2d at 15-16.

10. *Id.* at 15. Unless otherwise indicated, the facts are derived from the court of appeals opinion.

bank accounts and coded communications.[11] Eventually, federal authorities did detect this activity and the participants were charged with criminal violations of section 10(b) and Rule 10b-5,[12] the Mail Fraud Statute,[13] and the Anti-Conspiracy Statute.[14] Most of those charged fled the country to avoid prosecution,[15] while one pleaded guilty,[16] leaving Newman as the only defendant in this case.

The district court dismissed the government's indictment on the basis of a finding that this area of the securities law was so unsettled at the time of the defendant's activities that it did not give him "fair notice" that such conduct was illegal.[17] The lower court also ruled that the securities laws were not intended to reach fraud other than that committed against a purchaser or seller.[18]

The majority of a Second Circuit panel reversed the district court by holding that the scope of section 10(b) is not limited to fraud in the purchase-sale transaction.[19] Rather, it includes

---

11. *Id.* The other devices used in this scheme included: not using their names on account statements; keeping the coconspirators identities a secret from each other; paying for their trades with cash, treasury bills, or bearer bonds; avoiding contact with the two employees who supplied the information; and if necessary, lying if the government inquired about their trading. *See* Brief for the United States of America at 6, United States v. Newman, 664 F.2d 12 (2d Cir. 1981).

12. Under section 32(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78ff(a) (1976), criminal prosecutions can be brought for violations of section 10(b) or Rule 10b-5, with penalties of fines ranging up to $10,000, prison terms of up to five years, or both. The only other judicial remedy expressly included in the law is section 21(d), 15 U.S.C. § 78u(d) (1976), which gives the SEC the power to seek injunctive relief against violations of the statute or the Rule.

For a description of the various administrative remedies that can be brought by the Commission, *see generally* Jacobs, *Judicial and Administrative Remedies Available to the SEC for Breaches of Rule 10b-5*, 53 St. John's L. Rev. 397, 422-34 (1979).

13. 18 U.S.C. § 1341 (1976).

14. 18 U.S.C. § 371 (1976).

This casenote will only be discussing the securities law issues in *Newman*. As for the two other counts, the district court dismissed both, United States v. Courtois, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,024, at 91,301, and the Second Circuit unanimously reinstated them, United States v. Newman, 664 F.2d at 20-21.

15. United States v. Courtois, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,024, at 91,287 n. 1.

16. S.E.C. Digest, N.Y.L.J., Sept. 17, 1982, at 1, col. 5.

17. United States v. Courtois, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,024, at 91,296.

18. *Id.*

19. United States v. Newman, 664 F.2d at 16.

fraudulent conduct whose sole purpose is to put a person in a position to buy and sell securities.[20] Further, the court held that when the scope of the law is properly understood, the broad language of Rule 10b-5, by itself, should have given Newman sufficient notice that his actions were prohibited.[21]

This casenote will examine the two questions of law raised by the *Newman* decision: whether fraud against employers and their clients comes within the scope of section 10(b) and Rule 10b-5 and whether the defendant had "fair notice," consistent with due process, that his conduct was unlawful. To provide an adequate background for examining these issues, this note will review the development of the law regarding fraudulent nondisclosure in securities transactions from the common law through the *Chiarella* opinion. Next, it will present the opinions of both the district court and the court of appeals. The analysis section will compare and critically examine both decisions leading to the conclusion that the majority opinion of the Second Circuit panel correctly reflects the law regarding both the scope of Rule 10b-5 and the notice that the defendant was required to receive.

II. The Development of Nondisclosure Liability in the Context of Securities Transactions

A. *The Common Law*

Under common law principles of fraud, a party to a securities transaction, as in any business deal, has no obligation to reveal material information concerning that transaction of which the other party is not aware.[22] In ordinary "arms-length" commercial dealings, this rule is intended to promote diligence and shrewdness.[23] However, when a relationship of trust and confidence exists between the parties, such as between a principal and agent, a strict disclosure duty is imposed.[24]

20. *Id.* at 17-18.

21. *Id.* at 19.

22. W. Prosser, Handbook on The Law of Torts § 106, at 695-96 (4th ed. 1971). *See* Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 Cornell L.Q. 53, 56-57 (1960); Note, *Civil Liability Under Rule X-10b-5*, 42 Va. L. Rev. 537, 552-53 (1956).

23. *See, e.g.*, Conant, *supra* note 22, at 56-57.

24. Prosser, *supra* note 22, at 696-97; Restatement (Second) of Torts § 551(2)(a) & comment a (1977). *See* Keeton, *Fraud-Concealment and Non-Disclosure*, 15 Tex. L.

Eventually, state courts applied these general common law rules to specific problems arising from the trading of corporate securities.[25] One critical issue that developed concerned the disclosure duty of corporate directors, officers, and majority shareholders when they traded with ordinary shareholders on the basis of material nonpublic information that they obtained through their positions.[26]

Initially, the majority of courts held that these company insiders owed their allegiance solely to the corporation and thus had no disclosure obligation before buying or selling from a shareholder.[27] The minority view regarded these insiders as trustees of the company's shareholders,[28] and imposed a duty to disclose under the common law of fraud.[29] Between these two extremes, a number of courts that followed the majority rule recognized a limited obligation to speak that required insiders to reveal the occurrence of certain special facts about the company which would make the trade with the unknowing shareholder too unfair to enforce.[30]

B. *Rule 10b-5 and the Judicial Expansion of Fraudulent Nondisclosure*

Soon after the collapse of the stock market in 1929, Congress decided to restore public confidence[31] by regulating the

---

REV. 1, 11 (1936).

25. *See, e.g.*, Crowell v. Jackson, 53 N.J.L. 656, 657, 23 A. 426, 427 (1891); Rothmiller v. Stein, 143 N.Y. 581, 591-92, 38 N.E. 718, 719-20 (1894).

26. W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1167 (rev. ed. 1975).

27. *See, e.g.*, Clayton v. James B. Clow & Sons, 212 F. Supp. 482, 583 (N.D. Ill. 1962); Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659, 660 (1933). Under the majority rule, it is assumed that the shareholder can achieve the same results as through disclosure, by inspecting the corporation's books, which are open to them. *See* FLETCHER, *supra* note 26, at § 1168.1.

28. *See, e.g.*, King Mfg. Co. v. Clay, 216 Ga. 581, 118 S.E.2d 581, 584-85 (1961); Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232, 233-34 (1903). Under the minority rule it did not matter if the shareholder could get the necessary information by inspecting the company's books, since the insiders were held to have a fiduciary duty to disclose all relevant facts in a transaction with them. *See* FLETCHER, *supra* note 26, at § 1168.2.

29. *See supra* note 24.

30. *See, e.g.*, Strong v. Repide, 213 U.S. 419, 431-34 (1909); Agatucci v. Conadi, 327 Ill. App. 153, 157-58, 63 N.E.2d 630, 632 (1945); Buckley v. Buckley, 230 Mich. 504, 508, 202 N.W. 955, 956 (1925).

31. United States v. Naftalin, 441 U.S. 768, 775-76 (1979) (quoting S. REP. No. 47,

securities industry through the passage of two major pieces of legislation — the Securities Act of 1933[32] and the Securities Exchange Act of 1934.[33] Besides the protection of investors, a major goal of these laws was to restore integrity to the marketplace.[34] In order to create a sense of fair dealing, Congress also sought to promote relationships of trust and confidence in the industry.[35]

Among the provisions of the Exchange Act, section 10(b) contained a sweeping prohibition against fraud and gave the Securities Exchange Commission (SEC) the power to make rules to enforce it.[36] In 1942, the SEC enacted Rule 10b-5[37] which made it unlawful for "*any* person" to use "*any* device" or

---

73d Cong., 1st Sess. 1 (1933)). *See* H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933). In a letter in support of the 1933 Act, President Roosevelt stated that its purpose was to create "honest dealing in securities and thereby bring back public confidence." *Id. See generally* 1 L. Loss, Securities Regulation 119-21 (2d ed. 1961).

32. Securities Act of 1933, ch. 38, 48 Stat. 74 (1933) (current version at 15 U.S.C. §§ 77a-77aa (1976 & Supp. IV 1980)). This Act focuses on disclosure by the issuer concerning the company and its securities prior to their initial sale.

33. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (1934) (current version at 15 U.S.C. §§ 78a-78hh (1976 & Supp. IV 1980)). The general thrust of this Act is the regulation of trading after the initial issuance of the securities.

Other important legislation passed by Congress in this area includes: The Public Utility Holding Company Act of 1935, ch. 687, 49 Stat. 838 (1935) (current version at 15 U.S.C. §§ 79 to 79z-6 (1976 & Supp. IV 1980)); The Trust Indenture Act of 1939, ch. 41, 53 Stat. 1149 (1939) (current version at 15 U.S.C. §§ 77aaa-77bbbb (1976 & Supp. IV 1980)); The Investment Company Act of 1940, ch. 686, 54 Stat. 789 (1940) (current version at 15 U.S.C. §§ 80a-1 to 80a-52 (1976 & Supp. IV 1980)); and The Investment Advisers Act of 1940, ch. 686, 54 Stat. 847 (1940) (current version at 15 U.S.C. §§ 80b-1 to 80b-21 (1976 & Supp. IV 1980)).

34. United States v. Naftalin, 441 U.S. at 775-76. *See also* 78 Cong. Rec. 7697 (1934). In considering the passage of the Exchange Act, Representative Rayburn stressed the goal of integrity when he stated: "[w]e should have a marketplace for the exchange of securities, but it should be a clean and honest marketplace." *Id.*

35. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 11-12 (1971) (quoting H.R. Rep. No. 1383, 73d Cong., 2d Sess. 6 (1934)). *See also* H.R. Rep. No. 1383, 73d Cong., 2d Sess. 5 (1934) which states:

> If investor confidence is to come back to the benefit of exchanges and corporations alike, the law must advance. . . . Unless constant extension of the legal conception of a fiduciary relationship — a guarantee of "straight shooting" — supports a maturing and complicated economic system, easy liquidation of resources in which wealth is invested is a danger rather than a prop to the stability of the system.

Id.

36. Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1976).

37. 17 C.F.R. § 240.10b-5 (1982).

make "*any* untrue statement" or "engage in *any* act" that defrauds "*any* person, in connection with the purchase or sale of *any* security."[38]

It is generally accepted that Congress intended the broad terms of section 10(b) to act as a "catch-all" to deal with new kinds of fraud as they arose.[39] Yet, the language of neither the section nor the Rule expressly addresses the subject of nondisclosure.[40] Also, the brief legislative history offers very few clues as to Congressional intent on this subject.[41]

The courts initially treated the Rule as a mere codification of the common law rules of disclosure for corporate insiders.[42] The first indication that Rule 10b-5 imposed a broader disclosure duty came from the SEC in *In re Cady, Roberts & Co.*[43] This administrative decision held that a broker-dealer violated the Rule by purchasing stock based on information supplied by a partner in his firm who also happened to be a director in the company whose stock he bought.[44] The SEC extended the director's disclosure obligation to the broker-dealer on the basis of this "access" test:

> [F]irst, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and

---

38. *Id.* (emphasis added).

39. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202, 206 (1976). *Accord* Chiarella v. United States, 445 U.S. at 226. *See Securities Exchange Act of 1934: Hearings on Stock Exchange Regulation Before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 21 (1934).* Thomas Corcoran, representing the Roosevelt Administration, described the purpose of what was then called section 9(c) (later codified as section 10(b)), when he said:

> Subsection (c) says, "Thou shall not devise any other cunning devices." Of course subsection (c) is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices.

Id.

40. *See supra* note 4 for the text of the statute and the rule.

41. Chiarella v. United States, 445 U.S. at 226. *See* 5 A. Jacobs, *supra* note 4, § 6.01.

42. *E.g.*, Kardon v. National Gypsum Co., 73 F. Supp. 798, 801-02 (E.D. Pa. 1947) (officers and directors held liable); *In re* Ward La France Truck Corp., 13 S.E.C. 373, 380-81 (1943) (officers who were also majority shareholders held liable). *See also* Jennings, *Insider Trading of Corporate Securities: A Survey of Hazards and Disclosure Obligations Under Rule 10b-5*, 62 Nw. U.L. Rev. 809, 814-15 (1968).

43. 40 S.E.C. 907 (1961).

44. *Id.* at 913.

second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.[45]

Definitive judicial recognition of Rule 10b-5's broader scope came when the Second Circuit decided *SEC v. Texas Gulf Sulphur Co.*[46] In this case, the defendants included not only the corporation's directors and officers but also its employees who were accused of buying their company's securities without disclosing their knowledge of a significant mineral discovery by the corporation.[47] According to the court, the employees were also liable for trading without disclosure because Rule 10b-5 requires that:

> [a]nyone in possession of material inside information must either disclose it to the investing public or if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.[48]

By finding that "*anyone*" who holds inside information has the same liability that used to be reserved for directors, officers and majority shareholders, the Second Circuit paved the way for other courts to create a whole list of non-traditional insiders. For example, underwriters of corporate securities issues,[49] outside attorneys,[50] and accountants[51] who have obtained material nonpublic information while working for the corporation are among those held to have a duty to disclose or abstain from

45. *Id.* at 912.

46. 401 F.2d 833, 847-48 (2d Cir. 1968) (en banc), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969). Prior to *Texas Gulf*, some district courts did, however, look to the *Cady, Roberts* access test for guidance on a case-by-case basis. *See, e.g.*, Schoenbaum v. Firstbrook, 268 F. Supp. 385, 395 (S.D.N.Y. 1967), *aff'd*, 405 F.2d 200 (2d Cir.), *aff'd in part, rev'd in part*, 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied*, 395 U.S. 906 (1969); Ross v. Licht, 263 F. Supp. 395, 409 (S.D.N.Y. 1967).

47. SEC v. Texas Gulf Sulphur Co., 401 F.2d at 843-48.

48. *Id.* at 848.

49. *E.g.*, Shapiro v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 495 F.2d 228, 239 (2d Cir. 1974).

50. *E.g.*, United States v. Peltz, 433 F.2d 48 (2d Cir. 1970), *cert. denied*, 401 U.S. 955 (1971).

51. *E.g.*, Herzfelt v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112, 121-22 (S.D.N.Y. 1974).

trading.[52]

In addition to its creation of the "abstain or disclose" rule, *Texas Gulf* added a new gloss to the *Cady, Roberts* "access" test. While recognizing that the *Cady, Roberts* formula is the essence of Rule 10b-5, the court restated it so that the portion referring to the existence of some "relationship" to the company was dropped.[53] This construction was consistent with the entire tone of the opinion which stressed the unfairness of trading on information which one knows is unavailable to the other party in the transaction.[54]

The next expansion of Rule 10b-5 imposed an "abstain or disclose" duty on persons outside the corporation who trade on information tipped to them from sources inside the company. In *Texas Gulf*, the court held that the insider was liable for the trading of his tippee,[55] but it never decided whether the tippee also violated the Rule because none were named as defendants

52. With the addition of so many other classes to the list of traditional insiders, it is necessary to have a definition based on their common characteristics. One commentator has suggested that "[a]n insider is a person who: (1) possesses inside information; (2) knows or should know the information is nonpublic; and (3) receives the information in his business capacity and for a legitimate business reason by virtue of a relationship giving access, directly or indirectly, to the information." *See* 5 A. Jacobs, *supra* note 4, § 66.02[a], at 3-327.

53. SEC v. Texas Gulf Sulphur Co., 401 F.2d at 848. According to the court in *Texas Gulf*, the main point of *Cady, Roberts* was that:

> anyone 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," i.e. the investing public.

Id. (quoting *In re* Cady, Roberts & Co., 40 S.E.C. at 912). *Compare* the above language *with* what the SEC said in *Cady, Roberts, supra* note 45 and accompanying text. In *Cady, Roberts*, the SEC determined that, under Rule 10b-5, "[the Commission's] task . . . is to identify those persons who are in a *special relationship with a company* and privy to its internal affairs, and thereby *suffer correlative duties* in trading in its securities." 40 S.E.C. at 912 (emphasis added).

54. SEC v. Texas Gulf Sulphur Co., 401 F.2d at 848, 851-52. Under *Texas Gulf's* analysis, "Rule [10b-5] is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information." *Id.* at 848, *accord* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236 n.13 (2d Cir. 1974).

55. SEC v. Texas Gulf Sulphur Co., 401 F.2d at 843, 856 n.23. Defendant Coates, a director of Texas Gulf, was held liable for trading that resulted from a tip to his son-in-law, a broker, who in turn recommended the stock to his customers. *Id.*

in that case.[56] The first judicial decision to establish tippee liability was *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith.*[57] In *Shapiro,* while acting as the managing underwriter for a proposed debenture offer by Douglas Aircraft, Merrill Lynch learned that Douglas was about to announce sharply lower earnings estimates than it had previously predicted.[58] Before this news was made public, Merrill Lynch tipped it to certain preferred customers who in turn sold their holdings.[59] The Second Circuit held that the tippees in this case violated Rule 10b-5 because they knew or should have known that their information came from within the corporation and that this was not public knowledge.[60]

C. *The Supreme Court and Rule 10b-5*

1. *Expansion of scope*

Up to the time that the Second Circuit decided the *Shapiro* case, the Supreme Court had interpreted Rule 10b-5 and other securities legislation liberally.[61] For example, in *Superintendent*

56. *Id.* at 852-53.

57. 495 F.2d 228 (2d Cir. 1974). A number of courts had already accepted the concept of tippee liability, but liability was still based on some insider duty. *See, e.g.,* Radiation Dynamics v. Goldmuntz, 464 F.2d 876, 887, 890 (2d Cir. 1972); Ross v. Licht, 263 F. Supp. 395, 408, 410 (S.D.N.Y. 1967). Furthermore, the SEC had already established tippee liability in its administrative cases. *See, e.g., In re* Faberge, Inc., 45 S.E.C. 249, 254-55 (1973); *In re* Investors Mgm't Co., 44 S.E.C. 633, 639-41 (1971). Also, while *Cady, Roberts* did not use the term tippee in describing the broker-dealer in that case, it imposed liability for that kind of behavior. *See supra* notes 43-45 and accompanying text.

58. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d at 231-32.

59. *Id.* at 232. These tippee-clients of Merrill Lynch sold or sold short over 165,000 shares causing Douglas stock to drop sharply. *Id.* at 232-33.

60. *Id.* at 237-38. In order to distinguish between insiders and tippees, the following definition is helpful :

> A tippee is a person who: (1) possesses inside information; (2) knows or should know the information is nonpublic; (3) received the information other than in his business capacity and for a legitimate business reason; and (4) knows or should know the information "had been obtained improperly by selective revelation or otherwise."

5 A. Jacobs, *supra* note 4, § 66.02[a], at 3-328.

61. *See infra* notes 62-71. *See also* Tcherepnin v. Knight, 389 U.S. 332, 335-38 (1967) (a withdrawable capital share comes under the definition of a "security" in section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (1976), because this is remedial legislation and should be construed broadly); J.I. Case Co. v. Borak, 377 U.S. 426, 430-31 (1967) (creating an implied cause of action for proxy fraud under sec-

of Insurance v. Bankers Life & Casualty Co.,[62] the Court held that the "in connection with" clause of Rule 10b-5 should be construed "flexibly" to reach fraud "touching" on a securities transaction.[63] To support its position, the Court pointed to the language of section 10(b) which repeatedly uses the word "any" in describing the type of fraudulent conduct, the security, and the person which must be connected to the purchase or sale of securities.[64] It also referred to the legislative history of the Securities Exchange Act to show that Congress found that it was essential that the SEC have "broad discretionary powers" in pursuing fraud.[65]

Only a year later, in *Affiliated Ute Citizens v. United States*,[66] the Court further expanded the scope of Rule 10b-5 when it held that bank employees, acting as market makers for Ute tribe members who wished to sell their tribal stock, had an obligation to disclose that they were reselling the shares at a higher price in the market outside the tribe.[67] Since the undisclosed information concerned the market characteristics of the stock and not inside information about the corporation, liability could not be established under existing insider theories.[68] As in *Bankers Life*, the Court stressed the frequent use of the word

---

tion 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a) (1976)); SEC v. Capital Gains Research Bureau, 375 U.S. 180, 188-95 (1963) (holding that intent was not required to violate section 206(2) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6 (1976)).

62. 404 U.S. 6 (1971). In this case, the defendant purchased the stock of an insurance company through a scheme in which he paid for the cost of the acquisition by selling the company's assets. The plaintiff, a liquidator of the now broke corporation, sued the defendant for damages under Rule 10b-5. *Id.* at 6-8. Both the district court, 300 F. Supp. 1083, 1100 (S.D.N.Y. 1960), and the court of appeals, 430 F.2d 355, 360 (2d Cir. 1970), dismissed the case, holding that this conduct was not within the scope of the federal securities laws but was rather a common law action for misappropriation.

63. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. at 12-13.

64. *Id.* at 10.

65. *Id.* at 11-12 (quoting H.R. REP. No. 1383, 73d Cong., 2d Sess. 7 (1934)). In a footnote, the Court also quoted with approval the Second Circuit's conclusion in A.T. Brod v. Perlow, 375 F.2d 393, 397 (2d Cir. 1967), that "Section 10(b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase of sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception." *Id.* at 11 n.7.

66. 406 U.S. 128 (1972).

67. *Id.* at 152-53.

68. *See supra* notes 43-60 and accompanying text.

"any" in both the section and the Rule as supporting a liberal construction of their scope.[69] Also, the Court repeated its belief that it previously made in *SEC v. Capital Gains Research Bureau*[70] that the underlying purpose of the securities laws "was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry."[71]

2. *Restriction of scope*

Beginning in 1975 with its decision in *Blue Chip Stamps v. Manor Drug Stores*,[72] the Supreme Court began to apply a decidedly more restrictive and rigid analysis to section 10(b) and other areas of the securities laws.[73] In *Blue Chip*, the Court adopted the "purchaser-seller" standing rule for private damage suits[74] brought under Rule 10b-5.[75] This restriction was first set forth about twenty-five years earlier by the Second Circuit in *Birnbaum* v. *Newport Steel Corp.*[76]

---

69. Affiliated Ute Citizens v. United States, 406 U.S. at 151.

70. 375 U.S. 180, 186 (1963).

71. Affiliated Ute Citizens v. United States, 406 U.S. at 151 (quoting SEC v. Capital Gains Research Bureau, 375 U.S. at 186).

72. 421 U.S. 723 (1975).

73. *Id.* at 731-55. *See* L. Lowenfels, *Recent Supreme Court Decisions Under The Federal Securities Laws: The Pendulum Swings*, 65 GEO. L. J. 891, 892-900 (1977); Note, *The Trend Toward A Strict Construction of Rule 10b-5: Aaron v. SEC and Chiarella*, 13 CONN. L. REV. 549, 554-62 (1981).

74. The private right of action for damages was first implied from Rule 10b-5 in Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa. 1947). Twenty-five years later, the Supreme Court finally recognized this remedy in Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. at 13 n. 9.

75. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 749.

76. 193 F.2d 461 (2d Cir. 1952), *cert. denied*, 343 U.S. 956 (1952). In *Birnbaum*, the Second Circuit held that a corporation's decision to call off a merger does not give its shareholders standing to sue under Rule 10b-5 because they were neither defrauded purchasers nor sellers. *Id.* at 464. Most federal courts followed *Birnbaum* in determining standing in private damages actions under Rule 10b-5. *See, e.g.*, Sargent v. Genesco, Inc., 492 F.2d 750, 763 (5th Cir. 1974); Landy v. FDIC, 486 F.2d 139, 156-57 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); Mount Clemens Indus., Inc. v. Bell, 464 F.2d 339, 341 (9th Cir. 1972).

Over time, a major exception to this rule developed in which a number of circuits held that private plaintiffs seeking only injunctive relief did not have to be buyers or sellers. *See, e.g.*, Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 797-98 (2d Cir. 1969); Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 546-47 (2d Cir. 1967); Kahan v. Rosenstiel, 424 F.2d 161, 173 (3d Cir.), *cert. denied*, 398 U.S. 950 (1970); Britt v. Cyril

The *Birnbaum* holding was based on an analysis of the scope of section 10(b) which concluded that it "was directed *solely* at the type of misrepresentation usually associated with the sale or purchase of securities . . . . "[77] In contrast, *Blue Chip* focused its analysis on a search for the legislative intent behind granting private remedies under the securities laws.[78] For example, the Court pointed out that whenever Congress did grant such a privilege in the securities laws it was usually limited to purchasers or sellers.[79]

Unlike *Birnbaum, Blue Chip* further justified the imposition of the standing rule because of important policy problems resulting from the explosive growth of the implied private action.[80] The Court feared that, without the documentary evidence of a purchase-sale transaction, suits based on oral testimony, which would not be amenable to dispositive motions, might swamp the courts.[81] It also argued that abuse of oral testimony could be a particular danger in this kind of litigation and might lead to vexatious and frivolous suits.[82] Further, opening up the class of potential plaintiffs posed the problem of suits brought solely to harass by parties with little chance of winning on the merits.[83] According to the Court, a standing rule would

---

Bath Co., 417 F.2d 433, 436 (6th Cir. 1969). The theory behind this exception was best stated by Judge Feinberg:

> [T]he claim for damages . . . founders both on proof of loss and causal connection with the alleged violation of the Rule; on the other hand, the claim for injunctive relief largely avoids these issues, may cure harm suffered to continuing shareholders, and would afford complete relief against Rule 10b-5 violations for the future.

Mutual Shares Corp. v. Genesco, Inc., 384 F.2d at 547.

77. Birnbaum v. Newport Steel Corp., 193 F.2d at 464 (emphasis added).

78. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 729-31.

79. *Id.* at 735-36 (citing 15 U.S.C. §§ 77k, 77l, 78i, 78r (1976)).

The Court in *Blue Chip* also noted that Congress rejected a proposal by the SEC to add the phrase "or any *attempt* to purchase or sell any security" to section 10(b). *Id.* at 732 (citing 103 CONG. REC. 11636 (1957) (emphasis added)). It construed this as evidence of a Congressional intent that only purchasers or sellers be able to utilize a private cause of action, because of fears of "the extension of civil liability under § 10(b)." *Id.* at 732. (citing *SEC Legislation, Hearings on S. 1178-1182 before a Subcommittee of the Senate Committee on Banking and Currency,* 86th Cong., 1st Sess. 368 (1959)).

80. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 737.

81. *Id.* at 742-43.

82. *Id.* at 743.

83. *Id.* at 740-41. According to the Court, "strike suits" of this kind are brought not only to harass but also because the defendant may often settle even where the plaintiff has little chance of winning at trial. This is because great cost and disruption to the

control these problems by restricting potential "plaintiffs to those who have at least dealt in the security."[84]

One year after *Blue Chip*, the Supreme Court again limited Rule 10b-5 in *Ernst & Ernst v. Hochfelder*[85] by holding that one cannot commit fraud under the Rule without "scienter."[86] Looking at the language of section 10(b), the Court found that the words "manipulative," "device," and "contrivance" provided a clear indication that Congress intended to proscribe willful, as opposed to negligent, conduct.[87] The Court noted that whenever Congress created civil liability for negligence in the securities laws, it did so explicitly.[88]

The following year, in *Santa Fe Industries, Inc. v. Green*,[89] the Court, again focusing on the language of section 10(b), held that absent "manipulation" or "deception," the mere breach of a fiduciary duty does not by itself violate the law.[90] Under a broader interpretation, the Court argued, there was the danger of turning ordinary corporate mismanagement into a violation of the federal securities laws.[91]

These three cases exemplify a trend by the Supreme Court retreating from earlier decisions that stressed the need to "flexibly"[92] interpret section 10(b) and Rule 10b-5, toward a more rigid and literal construction of the broad terms contained in both.[93] In making these strict interpretations, however, the Court has emphasized practical policy reasons such as limiting

---

defendant's business is possible in meeting the massive discovery requests available to the plaintiff under the Federal Rules of Civil Procedure. *Id. See* FED. R. CIV. P. 26(b) ("parties may obtain discovery regarding *any matter* not privileged, which is relevant to the subject matter involved in the pending action . . . . " (emphasis added)).

84. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 747.

85. 425 U.S. 185 (1976).

86. *Id.* at 193. The Court defined "scienter" as "a mental state embracing intent to deceive, manipulate or defraud." *Id.* at 193-94 n. 12.

87. *Id.* at 199.

88. *Id.* at 207-08.

89. 430 U.S. 462 (1977).

90. *Id.* at 473-74.

91. *Id.* at 47 (citing Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. at 12). The Court stressed that since corporations are creatures of state law, it is that law which properly governs their internal operations. Santa Fe Indus., Inc. v. Green, 430 U.S. at 479.

92. *See supra* text accompanying note 63.

93. This trend can also be seen in the Court's restrictive interpretation of other sections of the securities laws. *See infra* note 207.

the growth of private actions,[94] preventing vexatious litigation,[95] and drawing a line between internal corporate mismanagement and securities fraud.[96]

D. *Chiarella v. United States: Nondisclosure of Market Information by an Outsider*

It was in this restrictive atmosphere that the government began to depart from the familiar landmarks of insider trading by applying Rule 10b-5 to persons outside the corporation who trade upon material nonpublic information generated in the marketplace.[97] The first of these cases to reach the Supreme Court was *Chiarella* v. *United States*.[98]

In *Chiarella*, the defendant worked for a financial printer that prepared materials for the bidding companies in tender offers.[99] While the items that Chiarella handled deliberately did not identify either the offeror or the target company, to prevent employees from misusing the information, the defendant was able to deduce some of the identities from the information available to him.[100] Using this knowledge, Chiarella bought stock in these takeover candidates and then sold it at a profit after the public announcement of the offer drove up the price.[101] When this scheme was discovered by the SEC, Chiarella entered into a civil consent decree to stop his trading and to disgorge his profits.[102] He was subsequently indicted for criminally violating section 10(b).[103]

Since the defendant was neither an insider of the corpora-

---

94. *See supra* note 80 and accompanying text.

95. *See supra* note 83 and accompanying text. *See also* Santa Fe Indus., Inc. v. Green, 430 U.S. at 478-79.

96. *See supra* note 91 and accompanying text.

97. *See, e.g.*, SEC v. Manderano [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,357 (D.N.J. 1978); SEC v. Primar Typographers, Inc., [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,734 (S.D.N.Y. 1976); SEC v. Sorg Printing Co. [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,767 (S.D.N.Y. 1974) and FED. SEC. L. REP. (CCH) ¶ 95,034.

98. 445 U.S. 222 (1980).

99. *Id.* at 224.

100. *Id.*

101. *Id.* By his trading, Chiarella made a little more than $30,000. *Id.*

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

103. *See* Chiarella v. United States, 445 U.S. at 225.

tion whose stock he traded, nor a tippee of an inside source, he did not fit within the liability formulas developed in previous Rule 10b-5 cases.[104] The majority of a Second Circuit panel had no trouble finding that prior Rule 10b-5 cases covered Chiarella's conduct.[105] The court argued that the *Texas Gulf* decision stressed that the underlying policy of Rule 10b-5 is "the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."[106] It further contended that the market cannot operate efficiently when people are allowed to personally profit by exploiting information they obtain from their "strategic places in the market mechanism."[107] Under this theory, the main reason for prohibiting corporate insiders from using inside information is that it gives them an unfair edge in trading with those who are unaware of such facts. Since one of the principal purposes of the securities laws was to ensure the "integrity of the marketplace,"[108] the majority concluded that the "abstain or disclosure" rule applied to "[a]nyone — corporate insider or not — who regularly receives material nonpublic information."[109]

The dissent[110] argued that no case had ever held an outsider liable for trading on market information and that to do so in this case would rewrite the law.[111] It also noted that section 10(b) proscribes fraud and that under the common law, nondisclosure does not become fraud unless there is a duty to speak.[112] Since Chiarella had no relationship to those who sold stock to him, the dissent contended that there was no disclosure obliga-

104. *See supra* notes 43-60 and accompanying text.

105. United States v. Chiarella, 588 F.2d 1358, 1364-65 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).

106. *Id.* at 1365 (quoting SEC v. Texas Gulf Sulphur, 401 F.2d at 848)).

107. *Id.* at 1365.

108. *Id.* (quoting United States v. Brown, 555 F.2d 336, 339 (2d Cir. 1977)). The majority pointed out that section 10(b) was designed to restore confidence in the market by proscribing "those maniuplative and deceptive practices which have been demonstrated to fulfill no useful function." *Id.* at 1369 (citing S. Rep. No. 792, 73d Cong., 2d Sess., at 6 (1934)). According to the majority, Chiarella's conduct fit this description. *Id.*

109. *Id.* at 1365.

110. United States v. Chiarella, 588 F.2d at 1373 (Meskill, J., dissenting).

111. *Id.* at 1373 (Meskill, J., dissenting).

112. *Id.* at 1375 (Meskill, J., dissenting) (citing Prosser, *supra* note 22, § 106).

tion.[113] While recognizing that the defendant did owe the offering companies a duty not to misuse secrets put in his trust,[114] it quoted the *Santa Fe* case for the proposition that "the term 'fraud' in Rule 10b-5 does not bring within the ambit of the rule 'all breaches of fiduciary duty in connection with a securities transaction.' "[115]

The dissent also emphasized that this was a criminal case which required that the government prove that the law gave the defendant "fair notice" that his conduct was illegal.[116] Noting that the standard for criminal prosecution under section 10(b) is "a clear and definite statement of the conduct proscribed,"[117] the dissent argued that no such statement existed in the section, the case law, or in "established custom and usage."[118]

The majority of the Supreme Court rejected the Second Circuit majority's conclusion and held that an unfair informational advantage by itself does not violate Rule 10b-5.[119] The Court stressed that situations involving financial unfairness are not always fraud.[120] Paralleling the Second Circuit dissent, the Court relied on the boundaries of traditional common law fraud to conclude that Rule 10b-5 does not create a disclosure obligation without some preexisting fiduciary duty or other relationship of

---

113. *Id.* (Meskill, J., dissenting).

114. While Chiarella's primary agency relationship was within his employer, *see infra* note 123 he was also a subagent of his employer's clients and owed them the same duties owed his employer. *See* RESTATEMENT (SECOND) OF AGENCY § 428 & comment b (1954).

115. United States v. Chiarella, 588 F.2d at 1375 (Meskill, J., dissenting) (quoting Santa Fe Indus., Inc. v. Green, 430 U.S. at 473)).

116. *Id.* at 1376-78 (Meskill, J., dissenting). The Supreme Court has held that a law is unconstitutionally vague when it "fails to give a person of ordinary intelligence *fair notice* that his contemplated conduct is forbidden by the statute." United States v. Harriss, 347 U.S. 612, 667 (1954) (emphasis added), *accord* Papachristou v. City of Jacksonville, 405 U.S. 156, 162 (1972).

117. United States v. Persky, 520 F.2d 283, 288 (2d Cir. 1975). In *Persky*, the Second Circuit held that both section 10(b) and Rule 10b-5 are not unconstitutionally vague on their face. Rather, the court found that these laws give a clear warning that "conduct fraudulent even under the most restrictive definition of the common law . . . is proscribed . . . . " *Id.*

118. United States v. Chiarella, 588 F.2d at 1377 (Meskill, J., dissenting). While the government presented a number of actions brought against outsiders as precedent, *see supra* note 97, the dissent argued that they all resulted in consent decrees or guilty pleas and did not provide sufficient notice. *Id.* at 1377 n. 6 (Meskill, J., dissenting).

119. Chiarella v. United States, 445 U.S. 222, 230, 235 (1980).

120. *Id.* at 232.

trust and confidence.[121] Since Chiarella was a stranger to the sellers in the transactions in question, the Court held that he owed them no duty to speak.[122]

This decision did not, however, entirely foreclose the possibility of using Rule 10b-5 in similar cases. The Court expressly left open the question of whether Chiarella's breach of his fiduciary duty to his employer and its clients would give rise to a violation of the Rule.[123] This alternative theory of liability was not considered by the Court because it found that it had not been presented squarely to the jury.[124]

The concurring and dissenting opinions, however, did discuss this theory. While agreeing that the jury was not properly charged, Justice Brennan believed that a duty to disclose is created under Rule 10b-5 when one "improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities."[125] Justice Stevens' concurrence found that reasonable arguments could be made for or against this theory.[126] Chief Justice Burger's dissent argued that the common law's purpose for denying a disclosure duty in arms-length business dealings — i.e., rewarding business acumen, hard work, and skill — are not promoted "when an informational advantage is obtained, not by superior experience, foresight or industry, but by some unlawful means."[127] The Chief Justice also contended that the repeated use of the word "any" in the statute indicated that Congress intended to reach more than just fraud by insiders.[128]

---

121. *Id.* at 227-28. *See supra* notes 22-24 and accompanying text.

122. *Id.* at 235.

123. Chiarella, as an agent of his employer, had a relationship of trust and confidence, which gave rise to a duty not to disclose or use, for either his own personal profit or to harm his employer, any confidential information given to him in his job. RESTATEMENT (SECOND) OF AGENCY §§ 387, 395 & comments a and c (1954). This relationship, in turn, gave rise to a disclosure duty under the common law of fraud. *See supra* note 26.

124. Chiarella v. United States, 445 U.S. at 236.

125. *Id.* at 239 (Brennan, J., concurring).

126. *Id.* at 237-38 (Stevens, J., concurring). The negative argument rested on the fact that the defrauded party was not a purchaser or seller of securities. Since that party did not have standing to sue under the "purchaser-seller" rule, there was arguably no violation of Rule 10b-5. *Id.* at 238 (Stevens, J., concurring).

127. *Id.* at 239-40 (Burger, C.J., dissenting).

128. *Id.* at 240-41 (Burger, C.J., dissenting). This analysis parallels that of earlier more liberal interpretations of Rule 10b-5 by the Court. *See supra* notes 64 & 69 and

After *Chiarella*, the SEC promulgated Rule 14e-3, which expressly proscribes both insider and outsider trading in the context of corporate tender offers.[129] Because the language of section 14(e),[130] the statute upon which the Rule is based, contains words that almost parallel section 10(b),[131] some critics argue that *Chiarella*'s interpretation of what constitutes fraud under the securities laws similarly restricts Rule 14e-3.[132] In the announcement accompanying the promulgation of the new Rule, the SEC disagreed with this construction.[133] It also stated its in-

---

accompanying text.

Justices Blackmun and Marshall never discussed this alternative theory because they agreed with the majority of the Second Circuit that an unlawful informational advantage violates Rule 10b-5. *Id.* at 245-52 (Blackmun, J., joined by Marshall, J., dissenting).

129. Rule 14e-3 provides in relevant part:

> (a) 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 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 or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foreign 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.

17 C.F.R. § 240.14e-3 (1982).

130. Securities Exchange Act of 1934, § 14(e), 15 U.S.C. § 78n(e) (1976) provides in relevant part that it shall be unlawful to make "any untrue statement of material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive or manipulative acts or practices, in connection with a tender offer . . . . " *Id.*

131. *Compare supra* note 129 (section 14(e)) *with supra* note 4 (section 10(b)).

132. *See* H. Heller, *Chiarella, SEC Rule 14e-3 and Dirks: "Fairness" Versus Economic Theory*, 37 Bus. Law. 517, 541-43 (1982): D. Block & H. Prussin, *"Outsider" Duties In Insider Trading*, Nat'l L.J., Dec. 28, 1981, at 19, 21, col. 3.

133. *See* Sec. Exch. Act Release No. 34-17,120 (Sept. 12, 1980), 45 Fed. Reg. 60,410, 60,412 & n.20. In its release, the Commission stated:

> [t]he *Chiarella* Court did not resolve whether trading while in possession of material, nonpublic market information misappropriated or obtained or used by unlawful means violates Rule 10b-5. The Commission continues to believe that such conduct undermines the integrity of, and investor confidence in, the securities markets, and that persons who unlawfully obtain and misappropriate material, nonpublic information violate Rule 10b-5 when they trade on such information.

tention to use the alternative theory in *Chiarella* to reach outsider trading with Rule 10b-5.[134]

III. *United States* v. *Newman*: Differing Views of the Misappropriation Theory

In 1981, the *Newman* case presented an opportunity to test the government's alternative theory in *Chiarella*. The facts of *Newman* closely parallel *Chiarella* in that both involve the misappropriation by an employee of confidential market information about an acquiring company's plans to make a tender offer.[135]

A. *The Opinion of the District Court: Focus on Fair Notice*

While acknowledging that "the question left open in *Chiarella*" was "squarely presented" before it,[136] the district court approached its analysis of Rule 10b-5 indirectly. Like the dissent to the Second Circuit's *Chiarella* opinion, the district court focuses on the fact that this was a criminal prosecution which required proof of a "clear and definite statement of the conduct proscribed" antedating Newman's conduct.[137] For this reason, the district court's analysis focused on whether the Exchange Act, the Commission's rules and the judicial decisions interpreting this body of law gave the defendant fair notice that trading on misappropriated market information was illegal.[138]

In answer to its question, the lower court held that until 1980, when the SEC explictly proscribed the abuse of market information in tender offers through Rule 14e-3,[139] this area of the law was so unsettled that Newman could not have received

> Moreover, the decision did not suggest any limitation on the Commission's authority under Section 14(e) to adopt a rule regulating trading while in possession of material, nonpublic information relating to a tender offer.

Id. at 60,412.

134. *Id.*

135. *Compare supra* text accompanying notes 10-11 *with supra* text accompanying notes 99-101 and accompanying text.

136. United States v. Courtois, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,024, at 91,290.

137. *Id.* at 91,289 (quoting United States v. Persky, 520 F.2d at 287)).

138. *Id.* at 91,290.

139. *See supra* note 129 and accompanying text.

the requisite notice.[140] Three reasons were given for this conclusion. First, it argued that the failure of the Commission to apply Rule 10b-5 to "warehousing," where the offeror intentionally leaks its plan to certain institutional traders,[141] indicated that persons unrelated to the target company can freely trade on market information.[142] This is because, the court argued, the principal reason for not applying Rule 10b-5 to "warehousing" was the offeror's lack of relationship to the target.[143] Since Newman also had no connection to the target, the district court contended that the defendant could have only concluded that his conduct was also not proscribed.[144]

The second reason advanced by the court was that during the development of Rule 14e-3, with only one exception,[145] the SEC's proposals for the Rule failed to mention any role for Rule 10b-5 in controlling outsider trading.[146] While the government

---

140. United States v. Courtois, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) at 91,296.

141. *See* Fleischer, Mundheim & Murphy, *An Initial Inquiry Into The Responsibility To Disclose Market Information*, 121 U. PA. L. REV. 798, 811-12 (1973). According to the authors, the offeror's purposes for tipping certain institutional investors include: maintaining the price of the target stock during the time of the offer by creating institutional interest; and financing the takeover by, for example, prompting institutions to take a position in the target company's stock under the assumption that they will tender their shares when the bid is made public. *Id.* at 812 (citing *SEC, Institutional Investor Study Report*, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. 2828-29, 2836 & 2847 (1971)).

142. United States v. Courtois, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) at 91,293.

143. *Id.* (quoting [Summary Volume] *SEC, Institutional Investor Study Report*, *supra* note 141, at XXII-III). To support its position, the court quoted extensively from this Commission report and included this passage:

> With respect, however, to passing on information about a prospective takeover effort to favored institutions, the persons who do so usually are the persons who plan the takeovers and ordinarily have *no relationship to the target company, nor do they have any fiduciary duty to that company or its shareholders.* This difference in relationships does not necessarily mean that such passing on of information concerning takeovers should be permitted, but it may well mean *that if such activities are to be prohibitted, this should be done by a rule specifically directed to that situation rather than by expanded interpretation of Rule 10 b-5 resting on a somewhat different theory* than that underlying that rule as to the obligations and duties of those who receive material undisclosed information.

Id. (emphasis is court's).

144. *Id.*

145. SEC Sec. Exch. Act Release No. 34-15,548 (Sept. 1979), 44 Fed. Reg. 9,956, at 9,977.

146. *See* United States v. Courtois, [1981 Transfer Binder] FED. SEC. L. REP. (CCH)

did bring a number of actions against outsiders during this same period,[147] the lower court discounted this fact.[148] As in the *Chiarella* dissent, the *Newman* court noted that these cases consisted of unlitigated guilty pleas and consent decrees which do not provide clear notice because they can be "entered into by parties who may want to avoid litigation for any number of reasons."[149]

The last factor given to support the district court's conclusion was that prior to and during the defendant's participation in this scheme, the courts had only applied Rule 10b-5 to nondisclosure by insiders and tippees who had a connection to the company whose stock they traded in, but never to outsiders trading on market information.[150] The court also noted that past "misappropriation" cases only concerned the theft of securities or their proceeds but not information.[151] Since these employees only breached their "duty of loyalty and ethical behavior" and did not affect the bankers' or offerors' ability to invest in the target corporations, the district court argued that this was not a federal crime but rather belonged in the domain of state law.[152]

In its final statements, the district court provided a key reason for its conclusion. Citing *Chiarella*,[153] *Texas Gulf*,[154] and

---

at 91,294 & n.16.

147. *See supra* note 97.

148. United States v. Courtois, [1981 Transfer Binder], FED. SEC. L. REP. (CCH) at 91,294-95.

149. *Id.* at 91,295 (quoting United States v. Chiarella, 588 F.2d at 1377 n.6 (Meskill, J., dissenting)). *See supra* note 118.

150. *Id. But see* Zweig v. Hearst Corp. 594 F.2d 1261, 1266-67 (9th Cir. 1979). In *Zweig,* a financial columnist wrote a positive article about a stock that he had purchased. Instead of basing liability on an insider theory, the court held that his failure to disclose his conflict of interest to his readers was unlawful. *See also* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

151. United States v. Courtois, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) at 91,295-96 (citing United States v. Brown, 555 F.2d 336, 339 (2d Cir. 1977); A.T. Brod & Co. v. Perlow, 375 F.2d 393, 395 (2d Cir. 1967); Allico Nat'l Corp. v. Amalgamated Meat Cutters & Butcher Workmen, 397 F.2d 727, 728 (7th Cir. 1968)).

152. *Id.* at 91,296.

153. Chiarella v. United States, 445 U.S. at 230. The portion of the opinion to which the *Newman* court was apparently referring states:

> Thus, administrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b) despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure. But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence

Birnbaum,[155] the court contended that federal law only proscribes "fraud perpetrated upon . . . purchasers or sellers of securities . . . ."[156] Based on this theory and the three notice arguments, the district court dismissed the Rule 10b-5 portion of the government's indictment.[157]

B. *The Opinion of the Court of Appeals*

1. *Scope of Rule 10b-5*

Initially, the majority opinion sought to undercut the district court's conclusion about the scope of section 10(b) by stressing the difference between private damage suits and government enforcement actions.[158] Noting that section 10(b) was enacted as a "regulatory and criminal piece of legislation,"[159] the

---

> between parties to a transaction. Application of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information.

Id.

154. SEC v. Texas Gulf Sulphur Co., 401 F.2d at 860. The portion of this opinion to which the *Newman* court seems to be referring states:

> Therefore it seems clear from the legislative purpose Congress expressed in the Act, and the legislative history of Section 10(b) that Congress when it used the phrase "in connection with the purchase or sale of any security" intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities.

Id. This quote was also a favorite of the defendant, Newman. *See* Brief for Defendant-Appellee at 7, 10, 13, 14, 15, & 18, United States v. Newman, 664 F.2d 12 (2d Cir. 1981).

155. Birnbaum v. Newport Steel Corp., 193 F.2d at 463. The portion of the opinion to which the court seems to be referring states:

> Section 17(a) of the 1933 Act only made it unlawful to defraud or deceive *purchasers* of securities . . . . The SEC's press release . . . which announced the Commission's adoption of Rule X-10B-5 shows that the Commission was attempting only to make the same prohibitions contained in Section 17(a) of the 1933 Act applicable to purchasers as well as sellers. That such was the only purpose of Rule X-10B-5 is made abundantly clear when the language of the Rule is compared with the language Section 17(a); the Commission simply copied Section 17(a) adding the words "any person" in place of "the purchaser" and a final clause "in connection with the purchase or sale of any security."

Id.

156. United States v. Courtois, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) at 91,296.

157. *Id.*

158. United States v. Newman, 664 F.2d at 16-17.

159. *Id.* at 16 (citing A.T. Brod & Co. v. Perlow, 375 F.2d 393, 396 (2d Cir. 1967)). In

majority pointed out that only the government is expressly given the power to sue under the statute, while the private remedy was implied from the law by the courts.[160] According to the court, the judiciary found it necessary to create the "purchaser-seller" standing rule because its remedy did not have boundaries like the statutory actions.[161] For these reasons, the majority concluded that the district court's reading of a buyer-seller limitation into Rule 10b-5 was an incorrect interpretation of the law.[162]

2. *Newman's fraudulent conduct violates Rule 10b-5*

Next, the court examined the nature of the defendant's fraud. Borrowing from Chief Justice Burger's *Chiarella* dissent, the majority found that the employees in this scheme "misappropriated — stole to put it bluntly — valuable nonpublic information entrusted to [them] in the utmost confidence."[163] This theft, it argued, defrauded the employers (investment bankers) of their reputation for confidentiality regarding their clients' secrets and thus had the same effect as if the employees stole money from them.[164] The majority also contended that this theft of information defrauded the clients because offerors generally base their decision to make a bid on the current market price of the target company.[165] Relying on the passage from a treatise on

---

A.T. Brod, the Second circuit concluded that:

> Neither § 10(b) nor Rule 10b-5, it appears, speaks in terms of limiting the nature of the violation to one involving fraud of "investors"; nor is there any justification for reading such an additional requirement into the Act. Section 10(b) was aimed at manipulative and deceptive devices which were employed "in connection with the purchase or sale of any security" and which contravened the rules and regulations established by the Commission. These rules and regulations were to be promulgated by the Commission "*in the public interest* or for the protection of investors . . . . " Similarly, Rule 10b-5, which prohibited fraudulent schemes in connection with the purchase or sale of securities was designed to protect both investors *and* "the public interest."

Id. (emphasis in original).

160. United States v. Newman, 664 F.2d at 16.

161. United States v. Newman, 664 F.2d at 17.

162. *Id.*

163. *Id.* (quoting Chiarella v. United States, 445 U.S. at 245 (Burger, C.J., dissenting)).

164. *Id.*

165. *Id.*

takeovers,[166] the court ruled that the defendant's subsequent trading "artifically inflated" the price that the offerors had to pay for the target.[167]

After establishing that Newman's conduct was fraudulent, the majority proceeded to show that this particular fraud was sufficiently "in connection with" the defendant's securities transactions so as to give rise to a violation of Rule 10b-5.[168] To construe the connection clause, the court looked to the Supreme Court's interpretation of that phrase in the *Bankers Life* case.[169] As noted earlier, *Bankers Life* concluded that section 10(b) must be "flexibly" construed and that the required connection occurs whenever fraud is "touching" upon a securities trade.[170] The *Newman* majority pointed out that the Second Circuit had previously held that this "touching" requirement is met where there is "a fraudulent scheme the accomplishment of which is directly related to the trading process."[171] Since the scheme Newman

166. *See* 13A B. Fox & E. Fox, Business Organizations, Corporate Acquisitions and Mergers § 27.05[4] (1981) (an increase in trading of the target company's shares will drive up its price causing the proposed takeover to become "less attractive" to the offering company).

167. United States v. Newman, 664 F.2d at 17-18.

Some commentators argue that the price adjustments caused by insider and outsider trading have a positive effect on the market because they allow stock prices to reflect their true value. These proponents of what has been called the "Efficient Capital Market Hypothesis" argue that regulation of insiders and outsiders stops the flow of information necessary for an accurate pricing system and thus should be abolished. *See, e.g.*, Fama, *Random Walks In Stock Market Prices*, 21 Fin. Analysts J., No. 5, 1965, at 55. The SEC has never recognized the validity of these arguments. *See, e.g.*, Remarks of John M. Fedders, Director of the SEC Division of Enforcement, Fall Meeting Of the Association of General Counsel, Washington D.C., October 8, 1981, at 9-10. Other commentators have also rejected the basis of this theory. *See, e.g.*, J. Lorie & M. Hamilton, The Stock Market — Theories and Evidence 98-112 (1973).

168. United States v. Newman, 664 F.2d at 18.

169. *Id.* Superintendent of Insurance v. Bankers Life & Cas. Co., 404 U.S. at 12-13. *See supra* note 62 and accompanying text. The *Newman* majority noted that this test has been interpreted rather broadly. United States v. Newman, 664 F.2d at 18. *See also* Mansbach v. Prescott Ball & Turben, 598 F.2d 1017, 1028 (6th Cir. 1979) which stated: "[t]his has been called a *de minimis* 'touch test' and few cases since *Superintendent of Insurance* have been dismissed for failure to satisfy the "in connection with" requirement of § 10(b) and Rule 10b-5." *Id.* (quoting Note, *The Pendulum Swings Farther: The "In Connection with" Requirement and Pretrial Dismissals of Rule 10b-5 Private Claims for Damages*, 56 Tex. L. Rev. 62, 66 (1977)).

170. *See supra* notes 62-63 and accompanying text.

171. United States v. Newman, 664 F.2d at 18 (quoting Competitive Assoc., Inc. v. Laventhol, Krekstein, Horwath & Horwath, 516 F.2d 811, 815 (2d Cir. 1975)).

participated in was pointless without his subsequent trading, the court ruled that the necessary connection was present.[172]

3. *Fair notice*

Throughout the majority opinion, the court also addressed the issue of fair notice. For example, it recognized that a number of years before this scheme began, various circuit courts had adopted an exception to the "purchaser-seller" rule where the plaintiff only sought injunctive relief.[173] According to the majority, these holdings highlighted the fact that the language of Rule 10b-5 does not contain any requirement that the fraud be against a buyer or seller.[174] Newman, thus, should have realized "that in a criminal action the courts likewise would follow the language of the Rule."[175]

With regard to the fraudulent nature of the defendant's conduct, the majority pointed to other areas of federal law where a fiduciary's misappropriation of secrets entrusted to him was held to be illegal.[176] From this, the court reasoned that Newman should not have believed that Congress intended any less substantial standard for fraud when it enacted the securities laws.[177]

The majority also noted that this scheme occurred within one year of the *Bankers Life* decision.[178] Given the proximity of this broad interpretation of the connection clause to Newman's activity, the clear implication of the majority's statement was that Newman should have recognized that his conduct fell within the reach of Rule 10b-5.

In the last paragraph of its analysis of the securities fraud, the majority made its major argument on the question of notice.

172. *Id.*

173. *Id.* at 17. *See supra* note 76.

174. *Id. See also supra* note 159.

175. *Id.*

176. Id. at 18. As examples of similar treatment, the *Newman* majority cited cases under: the federal statute against embezzlement and theft of public money, property or records, 18 U.S.C. § 641 (1976), *see* United States v. Girard, 601 F.2d 69, 70-71 (2d Cir.), *cert. denied*, 444 U.S. 871 (1979); and the federal mail fraud statute, 18 U.S.C. § 1341 (1976), *see* United States v. Kent, 608 F.2d 542, 544-45 (5th Cir. 1979), *cert. denied*, 446 U.S. 963 (1980); Abbott v. United States, 293 F.2d 310, 313-14 (5th Cir. 1956); United States v. Buckner, 108 F.2d 921, 926-27 (2d Cir.), *cert. denied*, 309 U.S. 669 (1940).

177. United States v. Newman, 664 F.2d at 18.

178. *Id.*

The court contended that, when the purchaser-seller rule is put in its proper perspective,[179] "Rule 10b-5's proscription of fraudulent and deceptive practices upon any person in connection with the purchase or sale of a security" by itself gave Newman fair notice that his conduct was illegal.[180] To support this proposition, the majority cited *United States v. Persky*,[181] which held that section 10(b) and Rule 10b-5 are not unconstitutionally vague but clearly warn that "conduct fraudulent even under the most restrictive definition of common law fraud . . . is proscribed . . . ."[182]

C. *The Dissenting Opinion*

The dissent refused to base Newman's conviction on a violation of section 10(b).[183] Citing *Chiarella* and *Blue Chip* as evidence of a "trend" by the Supreme Court to limit the scope of the statute to fraud against purchasers and sellers, the dissent was not convinced that the deceitful conduct in this case satisfied the "in connection with" requirement.[184]

IV. Analysis of the District Court and Second Circuit Majority Opinions

The primary factor that separates *Newman* from past cases brought under Rule 10b-5 is that to reach the defendant's conduct the government shifted its focus from the fraud against parties in the securities transaction to the fraud against the source of the nonpublic information. Such an approach was necessary because *Chiarella* requires some sort of trust relationship before imposing a disclosure duty and it held that none exists between outsiders and ordinary sellers in the market.[185] The alternative left open in *Chiarella* was to look instead at the fraud

179. *See supra* notes 159-62 and accompanying text.

180. United States v. Newman, 664 F.2d at 19.

181. 520 F.2d at 288. *See supra* note 117.

182. *Id.*

183. United States v. Newman, 664 F.2d at 20 (Dumbauld, J., dissenting). The dissent did, however, agree to reverse the district court on its dismissal of the mail fraud charge. *Id.*

184. *Id.*

185. Chiarella v. United States, 445 U.S. at 235. *See supra* note 122 and accompanying text.

used by the outsider to obtain the nonpublic market information that he later traded upon. By concentrating on a fraud not occurring in the trading process, a number of issues are raised. First, did Congress intend to limit the scope of section 10(b) to only those frauds involved in a securities transaction or did it intend a broader scope in protecting the integrity of the market? Second, in light of recent Supreme Court cases restricting the scope of Rule 10b-5, does an employee's misappropriation of secrets entrusted to him come within those new boundaries? Third, what is the minimal relationship required between the fraud and the actual purchase or sale of securities to meet the "in connection with" language of Rule 10b-5? Since *Newman* was a criminal enforcement action,[186] the final issue raised by this case is whether Newman's due process right to fair notice was violated, i.e., whether Rule 10b-5 gave the defendant clear warning that it is illegal for an outsider to trade on misappropriated nonpublic market information.

A. *Is the Scope of Rule 10b-5 Limited to Frauds Against Purchasers and Sellers?*

In Justice Stevens's concurrence to *Chiarella*,[187] and in the district court's opinion[188] and the dissent to the Second Circuit in *Newman*,[189] the theory was advanced that the "purchaser-seller" rule not only applies to standing in private damage actions but also delimits the scope of section 10(b). Under this interpretation of the law, the misappropriation theory, which focuses on the fraud outside the purchase-sale transaction, would be foreclosed. Since the Supreme Court has held that outsiders have no disclusure duty to an ordinary purchase or seller,[190] Rule 10b-5 would be unavailable as a means to control abusive trading by outsiders.

---

186. United States v. Newman, 664 F.2d at 16. *See supra* note 12.

187. Chiarella v. United States, 445 U.S. at 238 (Stevens, J., concurring). *See supra* note 126 and accompanying text.

188. United States v. Courtois, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,024, at 91,296. *See supra* note 156 and accompanying text.

189. United States v. Newman, 664 F.2d at 20 (Dumbauld, J., dissenting). *See supra* notes 183-84 and accompanying text.

190. Chiarella v. United States, 445 U.S. at 235. *See supra* note 122 and accompanying text.

To support its construction of the scope of Rule 10b-5, the district court in *Newman* cited *Birnbaum*, which first imposed the purchaser-seller standing rule on private damage actions under the Rule, finding that section 10(b) was intended to reach only those frauds occurring in transactions between buyers and sellers.[191] While the standing rule was subsequently accepted by the courts,[192] this analysis of the statute's scope was not.[193]

When the Supreme Court adopted the standing rule in *Blue Chip*, its analysis was clearly centered on private damage actions.[194] In justifying its conclusion, rather than relying upon *Birnbaum*'s analysis the Court focused on the fact that the securities laws generally limit private causes of action to injured buyers and sellers.[195] While the Court noted that Congress rejected a proposal to broaden the statute to include "attempts" to buy or sell, it also recognized that this amendment was defeated out of "fears of the extension of civil liability."[196]

Furthermore, the lengthy policy arguments used in *Blue Chip* to support its adoption of the standing rule show that the Court was principally concerned with controlling the problems caused by the explosive growth of the private damage action and not with restricting the scope of section 10(b).[197] To remedy this,

---

191. United States v. Courtois, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,024, at 91,296. *See supra* notes 76-77, 156 and accompanying text.

192. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975).

193. As noted earlier, the *Newman* majority pointed out that a number of circuits have recognized an exception to the standing rule when the plaintiff merely sought an injunction. United States v. Newman, 664 F.2d at 17. *See supra* note 76 and text accompanying note 173. Furthermore, the Supreme Court has at various times stated that the standing rule does not apply to SEC injunctions and criminal prosecutions brought by the Justice Department. *See, e.g.*, United States v. Naftalin, 441 U.S. at 768, 774 n. 6 (1979); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 469 n. 9. *See also* A. BROMBERG & L. LOWENFELS, *supra* note 4, § 4.7 (522), at 84.32 ("After *Supt. of Insurance*, then, *Birnbaum* survives significantly only for the buyer-seller requirement, which has been much reduced by other decisions"); A. JACOBS, *supra* note 4, § 38.01[d], at 2-48 ("exceptions have been made in the strict application of the *Birnbaum* doctrine. . . . The *Birnbaum* doctrine was undoubtedly intended as a standing rule only for private rights of action. The purchaser-seller requirement is inapplicable to criminal actions . . . .").

194. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 727-49.

195. *Id.* at 735. *See supra* note 79 and accompanying text.

196. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 732. *See supra* note 79.

197. For example, *Blue Chip* stressed that, when suits are brought by parties who do not have the documentary proof of the purchase-sale transaction, the courts are faced by dockets crowded with weak cases and vexatious litigation. Blue Chip Stamps v.

the Court sought to restrict the potential class of private litigants who could sue for damages.[198]

Toward the end of its opinion, the Court in *Blue Chip* succinctly described what that case stood for when it stated, "[w]e are dealing with a private cause of action which had judicially been found to exist, *and which will have to be judicially delimited one way or another* unless and until Congress addresses this question."[199]

The majority in *Newman* cited this statement when it concluded that the "purchaser-seller" restriction was imposed because the implied private right of action lacked the "contours" which the remedies expressly included in the statute have.[200] This proposition seems logical and consistent with the reasoning of *Blue Chip*.

Unlike private actions, which if unbounded by a standing rule threaten to bury the courts with vexatious and hard to prove cases, government enforcement efforts are constrained by budgetary limitations. The courts have frequently recognized that the SEC does not have the resources to adequately police all violations of the securities laws.[201] Individuals, acting as private attorneys-general discover and investigate more breaches of this law than does government.[202] Despite the drive by the SEC to stop this activity, the number of cases brought within the first twenty-one months of this program only totaled twenty-six and

---

Manor Drug Stores, 421 U.S. at 740-47. *See supra* notes 81-83 and accompanying text.

198. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 747. *See supra* note 84 and accompanying text.

199. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 747 (emphasis added).

200. United States v. Newman, 664 F.2d at 17. *See supra* note 161 and accompanying text.

201. *See, e.g.*, Fridrich v. Bradford, 542 F.2d 307, 324-25 n. 6 (6th Cir. 1976) (concurring opinion), *cert. denied*, 429 U.S. 1053 (1977); Woolf v. S.D. Cohn & Co., 521 F.2d 225, 227 (5th Cir. 1975), *vacated and remanded*, 426 U.S. 944 (1976); Gulf & Western Indus., Inc. v. The Great Atl. & Pac. Tea Co., 476 F.2d 687, 699 (2d Cir. 1973).

202. *See, e.g.*, J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964), *accord* Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 25 (1977); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d at 240 n.18.

Even today, with the SEC's current emphasis on insider trading under the Reagan administration, budget constraints have led to criticism that too many resources are being devoted to this area. This has forced the Commission to cut out less important defendants from its insider actions to save money. *See SEC Faced With Tight Budget, Is Paring 'Peripheral Defendants' From Complaints*, Wall St. J., Oct. 20, 1982, at 6, col. 2.

most of these were settled without trial by a consent order.[203] This contrasts sharply with the flood of private actions *Blue Chip* alluded to when it imposed the standing rule.[204]

Thus, as the *Newman* majority points out, the purchaser-seller rule is merely a judicial management tool that the courts found necessary when the remedy they created got out of control.[205] This conclusion is underscored by *Blue Chip*, which argued that the purpose of the standing rule was to control the policy problems presented by private damage actions by limiting the class of potential plaintiffs.[206] Rather than evidencing a trend toward limiting the scope of section 10(b), the adoption of the standing rule in *Blue Chip* seems more consistent with the current hostility of the Court toward implied private causes of action in the securities laws.[207] For these reasons, the *Newman* majority appears to be quite correct in concluding that the district court's reading of a buyer-seller restriction into section 10(b) was an "overbroad and incorrect summary of the law."[208]

---

203. *No-Tip Policy: Insider Trading Drive Trips Bankers, Lawyers As Well As Executives*, Wall St. J., Sept. 28, 1982, at 1, col. 1.

204. *See supra* notes 80-84 and accompanying text.

205. United States v. Newman, 664 F.2d at 17. *See supra* text accompanying note 161.

206. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 747. *See supra* notes 80-84 and accompanying text.

207. *See, e.g.*, Transamerica Mortgage Advisors, Inc., v. Lewis, 444 U.S. 11, 19-24 (1979) (no private right of action under section 206 of the Investment Advisors Act of 1940, 15 U.S.C. § 80b-6 (1976), but a limited implied right does exist under section 215, 15 U.S.C. § 80b-15 (1976)); Touche Ross & Co. v. Redington, 442 U.S. 560, 568-79 (1979) (no private right of action under section 17(a) of the Securities Act, 15 U.S.C. § 779(a) (1976)).

208. United States v. Newman, 644 F.2d at 17. *See supra* note 162 and accompanying text.

At least one federal court has misinterpreted the relevance of this portion of the *Newman* decision. In O'Connor & Assoc. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179, 1193 (S.D.N.Y. 1981), a district court held that an options trader may sue for damages against both insiders and tippees of a corporation who purchased options without disclosing their knowledge of an upcoming takeover. Even though the defendants had no fiduciary relationship with the plaintiff, the court, citing *Newman*, granted standing to sue on the basis of the insiders' duty to the investing public to either abstain or disclose, derived from their fiduciary duty to the corporation. *Id.* at 1183-88. This application of *Newman* disregards the clear distinction *Newman* drew between the limits the standing rule places on private damages actions and the broader scope of section 10(b), which sets the boundaries for government suits.

B. *Is This a Fraud Under Rule 10b-5?*

i. *Common law fraud*

Under the principle of common law agency, Newman aided his coconspirators in violating their fiduciary duty not to misuse confidential information entrusted to them in the course of their employment.[209] This special relationship also gave rise to a disclosure duty under the common law of fraud, which these employees breached by failing to report their activities to their employer.[210]

The common law also requires that the defrauded party be injured.[211] In this case, the employees clearly took something of value from their employers. Since secrecy is a key element in a successful tender offer,[212] firms like the investment bankers in this case take special precautions to prevent their employees from disclosing any information about their clients' plans.[213] Thus, as the *Newman* majority concluded, the damage caused by these employees to their banking houses' reputations as safe places for their clients' secrets "defrauded these employers as surely as if they took their money."[214]

The majority also found that the offerors were also defrauded because Newman's trading "artificially inflated" the market price of their target companies.[215] While the court's conclusion that there was a fraud seems correct, the reason given to support it is questionable. Arguably, pre-announcement trading patterns can tip the market about upcoming takeover bids.[216] It is also true, however, that such trading can go unnoticed, particularly if it involves small transactions in an actively traded

209. RESTATEMENT (SECOND) OF AGENCY §§ 387, 395 & comments a and c (1954). *See supra* note 123.

210. *See supra* notes 22-24 and accompanying text.

211. W. PROSSER, *supra* note 22, § 105, at 685-86.

212. *See* A. FLEISCHER, TENDER OFFERS: DEFENSES, RESPONSES AND PLANNING 4-6 (1978); *Full Disclosure of Corporate Equity Ownership in Corporate Takeover Bids: Hearings on S. 510 Before the Subcommittee on Securities of the Senate Committee on Banking and Currency*, 90th Cong., 1st Sess. 72 (1967) (testimony of Donald Calvin, Vice-President of the New York Stock Exchange).

213. *See supra* note 203, at 24.

214. United States v. Newman, 664 F.2d at 17.

215. *Id.* at 17-18. *See supra* notes 165-67 and accompanying text.

216. *See supra* note 212 and accompanying text.

stock, and will thus have no noticeable effect on the target's price.[217] The majority's reliance on a fraud against the offerors in their role as future investors is thus problematic because it requires the difficult job of proving that the target's price actually did go up due to the defendant's trading.[218]

A better approach would have been to recognize that the employees were subagents of the clients.[219] In this capacity, they had the same relationship of trust and confidence with the offerors as they did with their employers,[220] and therefore owed them the same disclosure duty.[221] Through this analysis, the employees' fraud can be based on a clear breach of duties owed because of their employment relationship, rather than gambling on whether the offerors actually suffered a loss in their tender offer.

ii. *Fraud under Rule 10b-5*

Even though Newman's scheme presents a clear case of common law fraud, it is still necessary to see whether it fits within recent Supreme Court pronouncements concerning what constitutes fraud under Rule 10b-5. For example, in *Chiarella*, the Court held that nondisclosure does not become fraud under section 10(b) unless there is a special relationship creating a duty to speak.[222] As noted above, the employees in this case had such an obligation to both their employers and the offerors.[223]

In *Santa Fe*, however, the Court also warned that a simple

217. Stock prices on the major exchanges are usually set by specialists who make their living dealing in particular stocks. Unless a stock is thinly traded, it will generally take a significant transaction to get the specialist to alter his price. *See generally* 2 L. Loss, Securities Regulation 1201-08 (2d ed. 1961).

218. *See* Wang, *Trading On Material Nonpublic Information On Impersonal Stock Markets: Who Is Harmed, And Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. Cal. L. Rev. 1217, 1236-38 (1981).

219. Since the investment bankers, who had a fiduciary duty to use the confidential information entrusted to them only for the purposes of aiding clients in their takeovers, acted under the control and for the benefit of those offering companies, they assumed an agency relationship with their clients. *See* Restatement (Second) of Agency § 14N (1958). The employees who were agents of their employers, became sub-agents of the clients. *See* Restatement (Second) of Agency § 5 & comment c (1958).

220. Restatement (Second) of Agency § 428 & comments a & b (1958).

221. *See supra* note 24 and accompanying text.

222. Chiarella v. United States, 445 U.S. at 227-28. *See supra* note 124 and accompanying text.

223. *See supra* note 221 and accompanying text.

breach of fiduciary duty does not violate Rule 10b-5 without manipulative or deceptive conduct.[224] It stressed that it did not want to turn ordinary corporate mismanagement into a violation of the securities laws.[225] Furthermore, in *Hochfelder*, the Court held that in order to commit fraud under the Rule, a defendant must have "scienter," which it defined as an "intent to deceive, manipulate or defraud."[226]

The conduct in *Newman* easily meets the requirements of *Santa Fe* and *Hochfelder*. In this scheme, the employees, secretly and without permission, took confidential information entrusted to them.[227] The deliberate deceitfulness of this enterprise is evidenced by the elaborate measures taken to avoid detection, such as using multiple brokers and foreign bank accounts.[228]

It would thus appear that Newman's conduct is of the kind considered to be fraudulent under Rule 10b-5. As the majority in *Newman* pointed out, this "was not simply corporate mismanagement."[229]

C. *Was this Particular Fraud Sufficiently "in Connection With" a Securities Transaction?*

Since the fraud in this case did not occur within the defendant's purchases or sales, the *Newman* majority had to establish that it had the requisite connection to those transactions so as to come within the scope of Rule 10b-5. To do this, the majority relied on the Supreme Court's liberal construction of the connection clause in *Bankers Life*.[230] In that case, the Court ruled that this clause should be construed "flexibly" to reach frauds "touching" the sale of securities.[231] Taken to the extreme, one

224. Santa Fe Indus., Inc. v. Green, 430 U.S. at 473-74. *See supra* text accompanying note 90.

225. *Id.* at 478-80. *See supra* note 91 and accompanying text.

226. Ernst & Ernst v. Hochfelder, 425 U.S. at 193. *See supra* notes 85-86 and accompanying text.

227. United States v. Newman, 664 F.2d at 15. *See supra* note 11 and accompanying text.

228. *Id.*

229. *Id.* at 17.

230. *See supra* notes 62-65, 169 and accompanying text.

231. *Id.*

could use this test to create securities fraud out of conduct with extremely tenuous connections to a securities transaction. As noted earlier, however, the Supreme Court in *Santa Fe* made it clear that Rule 10b-5 does not cover all breaches of fiduciary conduct that happen to have some connection with the purchase or sale of securities.[232]

The *Newman* majority avoided such broad liability by referring to a prior Second Circuit case which held that the "touching" test is met where the very purpose of the fraud is to put someone in position to buy and sell securities.[233] Looking at the facts of this case, the majority stressed that the defendant participated in his coconspirators misappropriation for only one reason — to enable him to buy and sell the stock of the target companies at a profit.[234]

By focusing on the purpose of the fraud, the majority construed the "touching" test so that it does not reach ordinary employee misconduct, but only those situations where the primary reason for committing the fraud is to enable one to buy or sell securities. In this way, section 10(b) can control outsider abuse of market information that threatens the integrity of the financial markets,[235] while maintaining a clear division between securities fraud and ordinary corporate mismangement.[236]

D. *Did Newman Have "Fair Notice" That His Conduct Violated Rule 10b-5?*

Criminal enforcement of Rule 10b-5 imposes on the government the additional burden of proving that the Rule gave the defendant a "clear and definite statement" that his activity was illegal.[237] In *Newman*, the district court and the Second Circuit

232. Santa Fe Indus., Inc. v. Green, 430 U.S. at 473-74. *See supra* note 90 and accompanying text.

233. United States v. Newman, 664 F.2d at 18 (quoting Competitive Assoc., Inc. v. Laventhol, Krekstein, Horwath & Horwath, 516 F.2d 811, 815 (2d Cir. 1975)). *See supra* note 171 and accompanying text.

234. *Id. See supra* note 172 and accompanying text.

235. *See supra* note 34 and accompanying text.

236. *See supra* note 91 and accompanying text.

237. United States v. Persky, 588 F.2d at 288. *See supra* note 117 and accompanying text.

majority came to opposite results on this issue.[238] In analyzing this question, it is necessary to compare the respective arguments of the two courts and then apply the relevant principles of "fair notice" developed by the Supreme Court.

In examining the competing arguments, two of the district court's reasons can be immediately dismissed. First, the lower court contended that "warehousing," where an offeror intentionally leaks its takeover plans to certain institutional investors, is similar to outsider trading on misappropriated market information, because both involve transactions based on nonpublic facts about the target company by persons unrelated to it.[239] Since the SEC refused to apply Rule 10b-5 to this practice, the district court concluded that Newman should have assumed that the same treatment would be given to his conduct.[240]

This analysis ignores critical differences between "warehousing" and the misappropriation of confidential takeover information by an employee entrusted with such secrets. In "warehousing," the offeror voluntarily reveals its secret plans. In Newman's case, however, the information was stolen, despite the offerors intention to keep it confidential. Thus, any notice the defendant received from the SEC's treatment of "warehousing" was irrelevant in the context of the fraud charged here.

The district court's conclusion also relied on the lack of references to Rule 10b-5 when Rule 14e-3 was being considered as a means to expressly control conduct like Newman's.[241] Yet, the lower court also found no significance in government actions during this same time period against outsiders trading on nonpublic market information, because they resulted in consent decrees and guilty pleas and had little value as precedent on which one could rely for notice.[242]

Placing more weight on one of these forms of government conduct than on the other makes little sense under the district

---

238. *Compare* United States v. Courtois, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,024, at 91,296 *with* United States v. Newman, 664 F.2d at 19. *See supra* notes 140 and 180 and accompanying text.

239. United States v. Courtois, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,024, at 91,292-93. *See supra* notes 141-43 and accompanying text.

240. *Id.* at 91,293. *See supra* note 144 and accompanying text.

241. *Id.* at 91,294. *See supra* notes 145-46 and accompanying text.

242. *Id.* at 92,294-95. *See supra* notes 147-49 and accompanying text.

court's own logic. Unlike the Congressional debate and hearings that shed light on the intended purposes of section 10(b), comment during administrative rulemaking under another section of the law, section 14(e), seems to have as much precedential value as the guilty pleas and consent decrees that the court discounted.

The district court's remaining argument stressed that no case had ever expressly held that Rule 10b-5 prohibited trading by outsiders on market information.[243] According to the court, this indicated that the securities laws were only intended to reach fraud against purchasers or sellers.[244] In contrast, the Second Circuit majority held that since the case law does not limit Rule 10b-5 to fraud against buyers or sellers, the broad language of the Rule gave Newman sufficient notice that his conduct was illegal.[245] Since this note has resolved the debate over the purchaser-seller rule in favor of the Second Circuit majority,[246] the notice issue in this case boils down to whether due process requires that either the statute or a prior case expressly warn Newman that his conduct was prohibited, or does the more general warning found in the language of the Rule suffice?[247]

Looking at the facts in this case, Newman was a professional securities trader, who managed a department at a New York brokerage firm.[248] The courts have recognized that professionals in the securities industry, unlike ordinary laymen, are responsible for knowing the laws that regulate their profession.[249]

---

243. United States v. Courtois, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,024, at 91,295. *See supra* note 150 and accompanying text.

244. *Id.* at 91,296.

245. United States v. Newman, 664 F.2d at 19. *See supra* notes 179-80 and accompanying text.

246. *See supra* notes 192-218 and accompanying text.

247. In analyzing these alternatives it should be stressed that the notice doctrine has principally developed in a first amendment context to draw a clear line between protected speech and criminal activity. *See, e.g.*, Marks v. United States, 430 U.S. 188 (1977); Grayned v. City of Rockford, 408 U.S. 104 (1972). The Supreme Court has ruled that notice challenges based on grounds other than the first amendment "must be examined in light of the facts of the case at hand." United States v. Mazurei, 419 U.S. 544, 550 (1975). *See* Buckley v. Valeo, 424 U.S. 1, 40-41 (1976); Smith v. Goguen, 415 U.S. 566, 573 (1974).

248. United States v. Newman, 664 F.2d at 15.

249. United States v. Persky, 588 F.2d at 28 n. 8; SEC v. Shapiro, 494 F.2d 1301, 1308 (2d Cir. 1974).

It is thus reasonable to expect that Newman could determine the scope of Rule 10b-5 by analyzing the law in a manner similar to the Second Circuit majority, rather than needing one case to expressly spell it out for him.

The fact that scienter is necessary to prove a Rule 10b-5 violation also supports this position.[250] The Supreme Court has ruled "that a scienter requirement may mitigate a law's vagueness, especially with respect to the adequacy of notice to the complainant that his conduct is proscribed."[251] As noted earlier, Newman had the requisite mental intent.[252]

In summary, since Newman was a professional, who was presumably familiar with the law surrounding Rule 10b-5, and since the scienter required to establish his liability mitigated the degree of explicitness necessary to give him fair notice, the fact that neither the statute nor case law expressly proscribe his conduct should not undermine the court's finding of sufficient notice. Rather, the cases holding that the purchaser-seller rule does not limit the scope of the statute, together with the commission of a common law fraud intended solely to put the defendant in a position to profitably buy and sell securities, support the contention that the broad warning of Rule 10b-5 provided Newman with sufficient notice that his actions were illegal.

V. Conclusion

In *Newman*, the Second Circuit clarified a serious misunderstanding about the impact of *Blue Chip* on the scope of section 10(b). The majority pointed out that the purchaser-seller rule was merely a response by the courts to the threat of being overwhelmed by hard-to-prove and vexatious litigation. It did not in any way limit the scope of this law whose very language evinces a clear intent to broadly deal with fraud connected to a securities transaction.

By focusing on the fraud against the employers and the offerors, the majority succeeded in satisfying *Chiarella*'s require-

250. Ernst & Ernst v. Hochfelder, 425 U.S. at 193. *See supra* notes 85-86 and accompanying text.

251. Village of Hoffman Estates v. Flipside, Hoffman Estates, 102 S. Ct. 1186, 1193 (1982).

252. *See supra* notes 11, 227 and accompanying text.

ment that there be some duty to speak before liability arises under Rule 10b-5. Punishing such flagrant breaches of trust and confidence is consistent with the original purposes of the securities laws.

The majority's interpretation of the connection clause to require that the sole purpose of the fraud be a later securities transaction kept the broad "touching" test of *Bankers Life* from being extended too far. Under the majority's theory, Rule 10b-5 is able to reach outsider trading without making ordinary corporate mismanagement a securities law violation.

Finally, the difficulty over notice in this case points to the problem the government faces when it uses a new theory of liability in a criminal case. As the *Newman* majority held, however, when the purchaser-seller limitation is put in its proper perspective, Rule 10b-5's broad prohibition against fraud connected to the purchase or sale of securities would give a market professional like Newman sufficient notice that his conduct was illegal.

James M. Robertson