SECURITIES—RULE 10b-5—CORPORATE OUTSIDER MAY BE LIABLE FOR FAILURE TO DISCLOSE OR ABSTAIN UNDER RULE 10b-5 BASED ON EMPLOYER-EMPLOYEE FIDUCIARY RELATIONSHIP—*United States v. Newman*, 664 F.2d 12 (2d Cir. 1981).

Corporate mergers, acquisitions and takeovers are an increasingly common phenomenon in today's business environment.[1] Typically, corporate securities, which are the targets of these moves, increase in value when information about the takeover or acquisition plan is made public.[2] A question which frequently arises is whether possessors of this information who trade in the securities before the information becomes public are liable under federal law.[3]

In *United States v. Newman*,[4] the Court of Appeals for the Second Circuit reinstated an indictment brought under section 10(b) of the Securities Exchange Act of 1934[5] (the 1934 Act) and rule 10b-5[6]

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[1] Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 544 (2d Cir. 1967); *see also* R. JENNINGS & H. MARSH, SECURITIES REGULATION 736 (4th ed. 1977); Note, *Cash Tender Offers: Judicial Interpretation of Section 14(e)*, 23 CLEV. ST. L. REV. 262 (1974).

[2] United States v. Newman, 664 F.2d 12, 17 (2d Cir. 1981).

[3] 5A A. JACOBS, THE IMPACT OF RULE 10b-5, § 187, at 8-24 (rev. 1980).

[4] 664 F.2d 12 (2d Cir. 1981).

[5] 15 U.S.C. § 78j(b) (1976). Section 10(b) states that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
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> . . . .
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> (b) To use or employ, in connection with the purchase or sale of any security, registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id. Section 10(b) does not by itself make unlawful any conduct or activity but rather confers on the Securities Exchange Commission (SEC) rulemaking power to condemn deceptive practices in the sale or purchase of securities. This is what rule 10b-5 does. Birnbaum v. Newport Steel Corp., 193 F.2d 461, 463 (2d Cir. 1952).

[6] 17 C.F.R. § 240.10b-5(1981). This rule, issued by the SEC under authority granted by section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976), provides that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
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> a) To employ any device, scheme, or artifice to defraud,
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> b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or
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> 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 (1981).

and held that an employee's fiduciary duty to his employer and its clients imposes an affirmative duty either to disclose his knowledge of an impending tender offer to prospective sellers of the target securities or abstain from trading when he obtains this knowledge in the course of his employment.[7] The defendant's misuse of information concerning planned tender offers is now clearly proscribed by rule 14e-3, which was adopted subsequent to the acts charged in the indictment.[8] By upholding the indictment under section 10(b) and rule 10b-5, the Second Circuit broke new ground by finding for the first time that a fiduciary duty owed to one person or entity was sufficient to form the basis of a duty to disclose to a different person or entity.[9]

Between 1973 and 1978, E. Jacques Courtois and Adrian Antoniu, two employees of separate investment banking firms, allegedly "misappropriated" confidential information[10] concerning planned mergers and acquisitions which was entrusted to their employers by corporate clients.[11] They communicated this information to James Mitchell Newman, a securities trader for a New York brokerage firm.[12] Newman, along with Franklin Carniol and Constantine Spyropoulos,[13] used the information to arrange stock purchases in compa-

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[7] 664 F.2d at 16.

[8] 17 C.F.R. § 240.14e-3 (1981). The text of this rule is, in pertinent 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:
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> (1) The offering person,
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> (2) The issuer of the securities sought or to be sought by such tender offer, or
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> (3) Any officer, director, partner, or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities 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 foregoing 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.

Id.

[9] 664 F.2d at 15.

[10] Since the district court had made no findings of fact for purposes of the appeal, the court assumed the facts alleged in the indictment to be true. *Id.*; *see* United States v. Von Barta, 635 F.2d 999 (2d Cir. 1980), *cert. denied*, 450 U.S. 998 (1981).

[11] 664 F.2d at 15. Both Courtois and Antoniu were employed by Morgan, Stanley & Co., Inc. between 1972 and 1975. Antoniu left Morgan, Stanley to work for Kuhn Loeb & Co., now known as Lehman Brothers Kuhn Loeb, Inc., in 1975. *Id.*

[12] *Id.*

[13] *Id.* Carniol was a Belgian resident and Spyropoulos was a Greek citizen living in Greece and France. *Id.*

nies which were targets of these mergers and takeover bids.[14] When the mergers and takeovers were announced, the value of the stocks greatly increased and the three realized substantial gains.[15] Courtois and Antoniu, the original sources of the secret information, shared in these profits.[16]

Courtois, Newman, Carniol and Spyropoulos[17] were indicted on thirteen counts of violating section 10(b)[18] and rule 10b-5,[19] thirteen counts of mail fraud[20] and with conspiracy[21] to commit these acts.[22] The securities fraud charges were based primarily on the defendants'

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[14] *Id.* In an effort to conceal these transactions, secret foreign bank accounts were used and the purchases were spread among the brokers. *Id.*

[15] *Id.*

[16] *Id.*

[17] Antoniu was an unindicted co-conspirator who cooperated with the government. United States v. Courtois, No. S-81 Cr.53, slip op. at 2 (S.D.N.Y. June 5, 1981), *rev'd sub nom.* United States v. Newman, 664 F.2d 12 (2d Cir. 1981).

[18] See *supra* note 5 for text of statute.

[19] See *supra* note 6 for text of rule. Newman was named in seven of these counts. United States v. Courtois, No. S-81 Cr.53, slip op. at 3 (S.D.N.Y. June 5, 1981), *rev'd sub nom.* United States v. Newman, 664 F.2d 12 (2d Cir. 1981).

[20] The charges alleged violations of the mail fraud statute, 18 U.S.C. § 1341 (1976). This statute provides that:

> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any counterfeit or spurious coin, obligation, security, or other article, or anything represented to be or intimated or held out to be such counterfeit or spurious article, for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined not more than $1,000 or imprisoned not more than five years, or both.

Id.

Newman was named in seven of these counts. United States v. Courtois, No. S-81 Cr. 53, slip op. at 3 (S.D.N.Y. June 5, 1981), *rev'd sub nom.* United States v. Newman, 664 F.2d 12 (2d Cir. 1981).

[21] These charges alleged violations of 18 U.S.C. § 371 (1976) which provides:

> If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined not more than $10,000 or imprisoned not more than five years, or both.
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> If, however, the offense, the commission of which is the object of the conspiracy, is a misdemeanor only, the punishment for such conspiracy shall not exceed the maximum punishment provided for such misdemeanor.

Id.

[22] 664 F.2d at 14.

breach of a fiduciary duty to the investment firms and their clients.[23] Newman thereafter moved in the District Court for the Southern District of New York to dismiss the indictment relative to him contending that the acts charged did not violate any federal criminal statute at the time of their occurrence.[24]

Judge Haight granted the motion, concluding "that 'there was no "clear and definite statement" in the federal securities laws which both antedated and proscribed the acts alleged in [the] indictment,' so as to give the defendant a reasonable opportunity to know that his conduct was prohibited."[25] He also dismissed the mail fraud counts for failing, as a matter of law, to charge a crime.[26] Accordingly, the corresponding conspiracy counts were also dismissed.[27]

In reversing the dismissal, the Second Circuit held that the indictment did allege acts and circumstances which fell within the area protected by section 10(b) and rule 10b-5.[28] It also reinstated the mail fraud and conspiracy charges.[29]

Disparate views regarding the nature of rule 10b-5 liability have led to conflicting judicial interpretations of the rule. Since its adoption in 1942, rule 10b-5 has generated a wealth of controversy concerning its appropriate scope.[30] This controversy embraces widely divergent theories of liability, ranging from the position that any person is liable for perpetrating fraud upon another if he trades securities without

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[23] United States v. Courtois, No. S-81 Cr.53, slip op. at 9 (S.D.N.Y. June 5, 1981), *rev'd sub nom.* United States v. Newman, 664 F.2d 12 (2d Cir. 1981). Specifically, the duties of honesty, loyalty, and silence were breached. *Id.*

[24] 664 F.2d at 3, 13. During the lower court proceedings, Newman was the sole defendant within the court's jurisdiction. 664 F.2d at 15. His three co-defendants had fled the United States. United States v. Courtois, No. S-81 Cr.53, slip op. at 38 app. 1 n.1 (S.D.N.Y. June 5, 1981), *rev'd sub nom.* United States v. Newman, 664 F.2d 12 (2d Cir. 1981).

[25] 664 F.2d at 14 (quoting United States v. Courtois, No. S-81 Cr.53, slip op. at 22 (S.D.N.Y. June 5, 1981), *rev'd sub nom.* United States v. Newman, 664 F.2d 12 (2d Cir. 1981)).

[26] *Id.*

[27] *Id.*

[28] *Id.* at 15.

[29] *Id.* In June of 1982, James Mitchell Newman was tried and convicted on all counts. Telephone conference with Franklin Velie, Esq., attorney for the defendant (July 7, 1982). He was sentenced to serve one year and one day in prison on each of 13 counts, all prison terms to run concurrently. On two other counts he received a suspended sentence and was placed on probation for three years. He was fined $10,000 and, as part of his probation, required to participate in some public service work. He is appealing the conviction. Telephone conference with Rose Marie Fugnetti, Clerk (Oct. 20, 1982).

[30] *See, e.g.*, Crane, *An Analysis of Causation Under Rule 10b-5*, 9 SEC. REG. L.J. 99 (1981); Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80 (1981); Note, *The Ninth Circuit Expands the 10b-5 Net to Catch a Columnist*—Zweig v. Hearst Corporation, 29 DE PAUL L. REV. 287 (1979); Note, *Omission and Nondisclosure Under SEC Rule 10b-5: A Distinction in Search of a Difference*, 7 FORDHAM URB. L.J. 423 (1979).

revealing all material information he possesses relative to the transaction,[31] to the proposition that even *insider* trading[32] should not be circumscribed by rule 10b-5's reach.[33] The problem is compounded by the tension between the generally recognized view that since federal securities laws are remedial in nature[34] they are intended to be construed "flexibly, not technically and restrictively,"[35] and a sound reluctance on the part of the courts to impute more to the laws than they actually contain.[36]

Rule 10b-5 expressly prohibits affirmative acts of fraud by any person in connection with the purchase or sale of securities.[37] The language of the statute attaches no relevance to the relationship between the issuing corporation, the offender, and those with whom he deals.[38] Moreover, the rule does not address situations involving pure silence.[39] For that reason, a judicially created rule requiring persons in possession of material nonpublic information to either disclose that information to those with whom they trade or abstain from trading has evolved to cover situations in which silence operates in the same way as overt acts of fraud.[40] Known as the disclose-or-abstain rule, it

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[31] Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 339-40 (1979). This theory embodies a belief that "parity of information" should exist among all participants in the marketplace. *See also* SEC v. Texas Gulf Sulphur, 401 F.2d 833, 851-52 (2d Cir. 1968)(en banc), *cert. denied sub nom.* Kline v. Securities & Exch. Comm., 394 U.S. 976 (1969).

[32] "Insider trading" has been defined as trading engaged in by officers, directors, and large (10%) shareholders. Manne, *Insider Trading and the Administrative Process*, 35 GEO. WASH. L. REV. 473, 474 (1967). This definition derives from section 16(b) of the 1934 Act, 15 U.S.C. § 78p(b) (1976). The definition of "insider" is not, however, mechanical. *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961), established that insider status results from being an officer, director, controlling shareholder or from standing in a special relationship with a corporation, thereby having access to information intended to be available only for a corporate purpose. *Id.* at 912.

[33] Barry, *The Economics of Outside Information and Rule 10b-5*, 129 U. PA. L. REV. 1307, 1328-29 (1981) (citing H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966)). For a more balanced approach, see Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798 (1973).

[34] *See In re* Cady, Roberts & Co., 40 S.E.C. 907, 910 (1961).

[35] Santa Fe Indus. v. Green, 430 U.S. 462, 475-76 (1977); *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197, 199 (1976).

[36] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 748-49 (1975); Santa Fe Indus. v. Green, 430 U.S. 462, 472 (1977). That judicial decisions may need to " 'put a limiting gloss upon the statutory language' " is by no means a novel idea. Hamling v. United States, 418 U.S. 87, 112 (1974) (quoting Manual Enterprises v. Day, 370 U.S. 478, 484 (1962)).

[37] *See* 17 C.F.R. § 240.10b-5 (1981), the text of which is set forth in note 6 *supra*. The terms "employ," "make," and "engage" clearly connote behavior which manifests itself in an external fashion. Even the prohibition against "omit[ting] to state a material fact," *id.* § 240.10b-5(b), operates only when other statements have already been made. *See In re* Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961).

[38] *See* 17 C.F.R. § 240.10b-5 (1981).

[39] See *supra* note 6 for text of the rule.

[40] *See In re* Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961). In the context of rule 10b-5, disclosure must be made only of *material*, nonpublic information. *Id.* The basic test of the

was designed to prevent corporate insiders from benefiting from "the inherent unfairness involved where a party takes advantage of . . . information knowing it is unavailable to those with whom he is dealing."[41]

The provisions of the Securities Act of 1933 (the 1933 Act) and the 1934 Act both incorporated[42] and superseded[43] the relevant common law principles.[44] The antifraud provisions of each[45] were aimed

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information's materiality is whether a reasonable person would attach importance to it in determining his choice of action in the transaction. *See* SEC v. Texas Gulf Sulphur, 401 F.2d 833, 849 (2d Cir. 1968) (enbanc), *cert. denied sub nom.* Kline v. Securities & Exch. Comm., 394 U.S. 976 (1969); RESTATEMENT (SECOND) OF TORTS § 538(2) (1977).

Disclose-or-abstain was formulated to apply to inside information. *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 & n.15 (1961). Inside information is nonpublic information that belongs to and emanates from the corporation whose securities are traded. Barry, *supra* note 32, at 1308-09. This is distinguishable from "market information" which is "information about events or circumstances which affect the market for a company's securities but which do not affect the company's assets or earning power." Fleischer, Mundheim & Murphy, *supra* note 33, at 799.

At least one commentator has argued persuasively that this distinction is unimportant and that the relevant inquiry is whether the information is material and nonpublic. *See* Brudney, *supra* note 31, at 329-33. Nevertheless, in this case Newman was not a corporate insider since he had no special relationship to the issuing corporation. He was an outsider who traded on market, not inside, material nonpublic information. To date, disclose-or-abstain liability under rule 10b-5 has been invoked in this type of situation only once, and on appeal was rejected by the Supreme Court. *See* Chiarella v. United States, 445 U.S. 222 (1980). These facts implicate the idea that Newman was deprived of the fair notice required by due process that his acts were unlawful under rule 10b-5.

[41] *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).

[42] *See* Comment, *Duty to Disclose Inside Information Arises From a Fiduciary or Special Relationship Between Parties to a Securities Transaction*, 58 WASH. U.L.Q. 1013, 1015-16 (1980).

[43] *See In re* Cady, Roberts & Co., 40 S.E.C. 907, 910 (1961).

[44] At common law, a duty to disclose existed only where the parties to a transaction stood in a confidential or fiduciary relation to each other. *See* W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 106, at 697 (4th ed. 1971). Prior to passage of the Securities Act of 1933, 15 U.S.C. § 77(a) (1976), plaintiffs bringing securities fraud actions had to depend on common law tort theories of deceit or general fraud. Brooks, *Rule 10b-5 in the Balance: An Analysis of the Supreme Court's Policy Perspective*, 32 HASTING L.J. 403, 405-06 & n.10 (1980). This dependence influenced later judicial consideration of the 1933 and 1934 Acts. Chiarella v. United States, 445 U.S. 222, 227-28 (1980); SEC v. Capital Gains Research Bureau, 375 U.S. 180, 192-94 (1963). *But see* Brooks, *supra*, at 410 (indicating that this impact was insubstantial before 1975).

Historically, the relationship between a corporate director or officer and a shareholder did not entail a duty to disclose. Brooks, *supra*, at 407. In the early part of this century, the Supreme Court imposed a disclosure obligation in those circumstances without disturbing the general rule that only where a confidential or fiduciary relationship bound the parties did a duty to disclose arise. *See* Strong v. Repide, 213 U.S. 419 (1909). In adopting the theretofore distinctly minority viewpoint, the *Strong* decision sanctioned the "special facts" doctrine which supported that viewpoint. This doctrine provided that even if relations between directors and shareholders of a corporation ordinarily were not of a fiduciary nature such as to require disclosure before trading, special facts or circumstances surrounding a transaction could compel disclosure. *Id.* at 431.

[45] Section 10(b)'s counterpart in the 1933 Act is section 17(a), 15 U.S.C. § 77q(a) (1976). Section 17(a)'s text virtually parallels that of rule 10b-5. The difference between the two is that

at staunching fraudulent activities "whether or not [those activities were] precisely and technically sufficient to sustain a common law action for fraud and deceit."[46] In *Strong v. Repide*,[47] a pre-Act holding, the Supreme Court held that nondisclosure of inside information by corporate directors purchasing the corporation's stock from its stockholders amounted to fraud under common law principles.[48] This led the Securities and Exchange Commission (SEC) and the courts to impose an affirmative duty of disclosure under rule 10b-5 upon corporate directors, officers, and controlling stockholders.[49]

In re Cady, Roberts & Co.[50] was the first case to articulate disclose-or-abstain and to formulate a flexible definition of the term "insider." Disclose-or-abstain requires that the possessor of material, nonpublic information obtained by virtue of his position must either disclose that information to those with whom he deals or abstain from dealing in those securities.[51] The term "insider" includes "those per-

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section 17(a) forbids fraud in "the offer or sale" of a security, while rule 10b-5 addresses purchases as well as sales.

[46] *In re* Cady, Roberts & Co., 40 S.E.C. 907, 910 (1961). Indeed, the SEC regarded the securities acts as the source of "a wholly new and far-reaching body of Federal corporation law." *Id.*

[47] 213 U.S. 419 (1909).

[48] *Id.* at 431.

[49] *E.g.*, Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951); Kardon v. National Gypsum Co., 73 F. Supp. 798, *modified*, 83 F. Supp. 613 (E.D. Pa. 1947); *In re* Ward La France Truck Corp., 13 S.E.C. 373 (1943). This development was expressly recognized in *In re* Cady, Roberts & Co., 40 S.E.C. 907, 911 & n.13 (1961).

[50] 40 S.E.C. 907 (1961).

[51] *Id.* at 911. The SEC articulated the rule as follows:

> [I]nsiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclsoure in these circumstances constitutes a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forego the transaction.

Id. This language in *Cady, Roberts* has been given an expansive interpretation, most notably by the Court of Appeals for the Second Circuit in SEC v. Texas Gulf Sulphur, 401 F.2d 833, 848 (2d Cir. 1968)(en banc), *cert. denied sub nom.* Kline v. Securities & Exch. Comm., 394 U.S. 976 (1969). Many commentators argue that the holding of *Cady, Roberts* was based on the principle of fairness. *See, e.g.*, Brudney, *supra* note 31, at 346. This is true to a point, but cannot obscure the fact that *Cady, Roberts* expressly predicates the duty to disclose or abstain upon a relationship giving access to material, nonpublic information. 40 S.E.C. at 912. The unfairness discussed in *Cady, Roberts* results from a breach of the duty to disclose or abstain but it does not create the duty. *Id.*

It is important to remember in analyzing *Cady, Roberts* that the fiduciary obligation arose because the one obligated was deemed an insider by reason 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." *Id.* Therefore, even though *Cady, Roberts* extended the meaning of the term "insider" to corporate employees who may not have been officially designated as officers or directors, and to corporate agents, and to "tippees" of either, it did not discard the insider requirement when applying disclose-or-abstain.

sons who are in a special relationship with a company and privy to its internal affairs," as well as the traditional categories of directors, officers, and controlling shareholders.[52] An integral element of an insider's duty to disclose is that he acquire his information by virtue of his position *vis-à-vis* the issuing corporation.

When the Second Circuit decided *SEC v. Texas Gulf Sulphur*,[53] it altered the basic qualifications of an insider. Whereas *Cady, Roberts* had rooted insider status in a special relationship to the issuing corporation, *Texas Gulf Sulphur* held that mere possession of material inside information compelled disclosure.[54] Thus, no special relationship to the corporation was necessary.[55] After acknowledging that disclose-or-abstain was based upon traditional fiduciary concepts or the "special facts" doctrine,[56] the Second Circuit then concluded that the principle applied to anyone in possession of material inside information.[57] Thus, the court's effective repudiation of the insider requirement potentially allowed a person with no relationship to the issuing corporation to be held liable for failing to disclose under rule 10b-5 if he somehow managed to come into possession of material inside information.

While the *Texas Gulf Sulphur* court stated that it had derived this rule from *Cady, Roberts*,[58] that case does not support such an interpretation since its holding was limited to insiders.[59] Apparently, the Second Circuit justified its abandonment of the insider prerequisite with the conviction that rule 10b-5 was "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."[60] Moreover, the court went so far as to declare that parity-of-information[61] was the purpose of rule 10b-5,[62] a position the

[52] 40 S.E.C. at 912. The sentence concludes thus: "and thereby suffer correlative duties in trading in *its* securities." *Id.* (emphasis supplied). This indicates that the rationale is aimed at those situations where the traded securities belong to the corporation to which the obliged trader is an insider.

[53] 401 F.2d 833 (2d Cir. 1968)(en banc), *cert. denied sub nom.* Kline v. Securities & Exch. Comm., 394 U.S. 976 (1969).

[54] *Id.* at 848.

[55] *Id.*

[56] *Id.* The "special facts" doctrine originated in Strong v. Repide, 213 U.S. 419, 431 (1909). *See supra* note 44 and accompanying text.

[57] 401 F.2d at 848. The court consistently characterized the information as "inside." Considering the extensive reach of the rationale, however, it is reasonable to conclude that the Second Circuit made no fine distinction between "inside" information and "market" information and that the resultant rule would actually encompass all material, nonpublic information.

[58] *Id.*

[59] See *supra* notes 49-51 and accompanying text.

[60] 401 F.2d at 848.

[61] See *supra* note 31 and accompanying text.

[62] *See* SEC v. Texas Gulf Sulphur, 401 F.2d at 851-52.

Supreme Court categorically rejected in a later case.[63] Further, the Second Circuit's broad interpretation of disclose-or-abstain in *Texas Gulf Sulphur* was unnecessary since the facts were confined to an insider situation.[64]

In *United States v. Chiarella*,[65] the Court of Appeals for the Second Circuit affirmed the defendant's conviction for criminal violation of rule 10b-5 by relying on the rule it established in *Texas Gulf Sulphur* that anyone possessing material inside information was required to either disclose or abstain. This decision was later reversed by the Supreme Court.[66] In keeping with the *Texas Gulf Sulphur* rule, the court of appeals deemed it "irrelevant" that Chiarella was not an insider of the corporation whose securities he traded because, as a financial printer, he was "as inside the market itself as one could be."[67] The Second Circuit then articulated a test of "regular access to market information," holding that anyone regularly receiving material, nonpublic information was forbidden to trade on the basis of it without honoring an affirmative duty of disclosure.[68]

In his dissenting opinion in *Chiarella*,[69] Judge Meskill departed from the majority for reasons which formed part of the basis for Judge Haight's dismissal of Newman's indictment.[70] The dissent found it particularly significant that no case put forth by the Government imposed criminal liability on anyone, insider or outsider, for section 10(b) nondisclosure. Even civil cases, Judge Meskill noted, restricted nondisclosure liability to insiders, their tippees[71] or those standing "in a special relationship with other traders."[72]

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[63] Chiarella v. United States, 445 U.S. 222, 233 (1980). The *Chiarella* Court also rejected the theory that a duty to disclose arises from mere possession of nonpublic market information. *Id.* at 235. This would seem to repudiate the Second Circuit's theory enunciated in SEC v. Texas Gulf Sulphur, 401 F.2d at 848, that mere possession of material inside information results in a duty to disclose unless this duty hinges on the distinction between market information and inside information. See *supra* note 40.

[64] At least one commentator has argued that courts, litigants, and commentators have interpreted rule 10b-5 in the same manner as they would a congressional statute and that this is "an indefensible approach to an administrative regulation." Manne, *supra* note 32, at 474.

[65] 588 F.2d 1358 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).

[66] 445 U.S. 222 (1980).

[67] 588 F.2d at 1364.

[68] *Id.* at 1365. Had the Second Circuit's decision been affirmed, this would have resolved the question whether material inside information, or material market information, or both, give rise to a duty to disclose based on possession alone. See *supra* notes 40 & 63.

[69] 588 F.2d at 1373 (Meskill, J., dissenting).

[70] United States v. Courtois, No. S-81 Cr. 53, slip op. at 19 (S.D.N.Y. June 5, 1981), *rev'd sub nom.* United States v. Newman, 664 F.2d 12 (2d Cir. 1981).

[71] A tippee is a person who receives material nonpublic information from an insider. Comment, *supra* note 42, at 1017 n.31.

[72] 588 F.2d at 1373 (Meskill, J., dissenting).

The dissent asserted that fraud under rule 10b-5 did not include all breaches of fiduciary duty involving securities transactions.[73] Judge Meskill could not uphold Chiarella's conviction because to do so would inappropriately stretch existing law to close a gap which should properly be remedied by an SEC rule or by congressional legislation.[74] Further, the dissent stressed that Chiarella was deprived of fair notice that his conduct was criminal because neither the statute's language, nor prior judicial interpretation, or established custom and usage provided such notice.[75] Finally, Judge Meskill concluded that circumstances sufficient to create a duty to disclose did not arise in situations involving only regular receipt of market information, absent a congressional enactment or an SEC rule.[76]

The Supreme Court in *Chiarella v. United States*[77] agreed with Judge Meskill that the Second Circuit's expanded application of disclose-or-abstain to a purchaser in Chiarella's position must be rejected.[78] To do otherwise, the Court reasoned, would be to recognize "a general duty between all participants in market transactions to forgo actions based on material, nonpublic information."[79] The *Chiarella* Court also remarked that neither the SEC nor Congress had adopted a parity of information rule; moreover the language and legislative history of rule 10b-5 did not warrant one.[80]

The Court stipulated that a duty to disclose must emanate from a specific relationship between two parties.[81] Since Chiarella owed no duty to the sellers of the securities he purchased,[82] the Supreme Court

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[73] *Id.* at 1375 (Meskill, J., dissenting). This point was ignored altogether by the Second Circuit in *Newman*.

[74] *Id.* at 1376 (Meskill, J., dissenting).

[75] *Id.* at 1377 (Meskill, J., dissenting). Judge Haight adopted that point in his opinion. United States v. Courtois, No. S-81 Cr. 53, slip op. at 7 (S.D.N.Y. June 5, 1981), *rev'd sub nom.* United States v. Newman, 664 F.2d 12 (2d Cir. 1981).

[76] 588 F.2d at 1378 (Meskill, J., dissenting).

[77] 445 U.S. 222 (1980).

[78] *Id.* at 232-33.

[79] *Id.* at 233.

[80] *Id.* Further, the *Chiarella* Court noted that "administrative and judicial interpretations [had] established that silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b) . . . [only if] premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." *Id.* at 230.

[81] *Id.* at 233.

[82] The Supreme Court found that:

> [n]o duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.

Id. at 232-33.

concluded that he could not be guilty of fraud based on pure silence.[83] The Court expressly declined to decide whether Chiarella had breached a duty to the acquiring corporation when he acted upon information obtained through his position as employee of the acquiring corporation's hired printing house, because this theory had not been presented to the jury at the trial.[84] Consequently, the Court reserved the issue which the Second Circuit faced in *Newman*.[85]

The district court's dismissal of the securities charges in *Newman* was based on an absence of fair notice to the defendants that their acts were criminal under rule 10b-5.[86] Although such conduct is now clearly unlawful under rule 14e-3,[87] Judge Haight decided that at the time Newman acted "neither courts, commentators, nor the SEC in its rule-making or enforcement capacities had stated that rule 10b-5 extended to a non-insider's breach of a fiduciary duty owed to the acquiring corporation in a tender offer."[88] Consequently, the court concluded that the imposition of a criminal sanction would be improper.[89]

Judge Haight began his analysis of the securities fraud by considering the result in *Chiarella v. United States*.[90] Chiarella was convicted for his failure to disclose his knowledge to the sellers of target company shares[91] but the Supreme Court reversed the conviction because it found that Chiarella was under no obligation to those sellers. Like Chiarella, Newman was indicted for his failure to disclose, but this requirement was based on a duty owed to the employer investment firms and their clients rather than a duty owed to the sellers.[92] Judge Haight found that rule 10b-5 was not intended and did not properly apply to situations which did not involve corporate insiders and that the employer-employee relationship was not of the kind encompassed by the rule.[93]

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[83] *Id.* at 233.

[84] *Id.* at 235-36.

[85] *Id.* at 236. In *Newman*, the issue was framed in terms of a breach of duty to the employer as well as to the clients. 664 F.2d at 16.

[86] United States v. Courtois, No. S-81 Cr. 53, slip op. at 22 (S.D.N.Y. June 5, 1981), *rev'd sub nom.* United States v. Newman, 664 F.2d 12 (2d Cir. 1981).

[87] *Id.* at 13.

[88] *Id.* at 22. The acquiring corporations in this case were the investment firm's clients.

[89] *Id.* at 24.

[90] 445 U.S. 222 (1980).

[91] United States v. Courtois, No. S-81 Cr. 53, slip op. at 4-5 (S.D.N.Y. June 5, 1981), *rev'd sub nom.* United States v. Newman, 664 F.2d 12 (2d Cir. 1981).

[92] *Id.* at 9.

[93] *Id.* at 14, 17-20.

To extend rule 10b-5 sanctions to a breach of a fiduciary duty owed to an employer added, in the court's view, " 'a gloss to the operative language of the statute quite different from its commonly accepted meaning.' "[94] This extension was unwarranted, Judge Haight continued, because Newman was not an insider of the target corporation acting on inside information.[95] The companies whose securities he traded were not the companies to whom he allegedly owed a fiduciary duty.[96] Therefore, the district court concluded that the connection between the fiduciary duty and the fraudulent trading, which was required after *Chiarella*, was absent in Newman's case.[97]

The district court considered three factors to be of prime importance in deciding the fair notice question. First, the SEC had expressly refused to employ rule 10b-5 to prohibit the similar activity of warehousing.[98] Second, SEC statements anticipating a need for rule 14e-3 lacked any reference to rule 10b-5's applicability to non-inside, market information.[99] Third, prior to the time Newman acted, liability for nondisclosure under rule 10b-5 was found only in circumstances where the offender was a corporate insider who breached a fiduciary duty to a purchasing or selling shareholder.[100]

Warehousing is the practice whereby a prospective tender offeror leaks advance knowledge of its plans to friendly investors who then buy the targeted shares for later sale to the offeror.[101] This conduct paralleled Newman's actions in a fundamental manner, according to Judge Haight, because it involved the trading of a target company's securities on the basis of nonpublic information by an investor unrela-

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[94] *Id.* at 10 (quoting Santa Fe Indus. v. Green, 430 U.S. 462, 472 (1977)).

[95] *Id.* at 11.

[96] *Id.* at 11-12. The lower court found support for this interpretation in the SEC's decision in *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961), as well. United States v. Courtois, No. S-81 Cr. 53, slip op. at 12 (S.D.N.Y. June 5, 1981), *rev'd sub nom.* United States v. Newman, 664 F.2d 12 (2d Cir. 1981).

[97] United States v. Courtois, No. S-81 Cr. 53, slip op. at 10-11 (S.D.N.Y. June 5, 1981), *rev'd sub nom.* United States v. Newman, 664 F.2d 12 (2d Cir. 1981). Judge Haight reasoned from his examination of *Chiarella* that actionable fraud in a securities transaction where the alleged fraudulent act is an omission must rest on a duty to disclose. *Id.* at 10. That duty derived from a "special relationship," an insider status, as *Cady, Roberts* pointed out. *Id.* Such a special relationship had been confined to situations involving corporate insiders (or their tippees) and inside information. *Id.* at 10-11. Since Newman was not an insider and inside information was not involved, Judge Haight concluded that rule 10b-5 did not apply. *Id.* at 11-12.

[98] *Id.* at 14.

[99] *Id.* at 14, 17.

[100] *Id.* at 14.

[101] *Id.*

ted to that company.[102] The district court noted that the SEC had excluded warehousing from the ambit of rule 10b-5 for the very reason that there existed no relationship to the target company and thus no fiduciary duty between the purchaser and the selling shareholder.[103] Consequently, Judge Haight decided that rule 10b-5 could not apply to Newman's behavior either.[104]

The district court stated that when the SEC solicited public comment regarding the extent to which nonpublic market information should be disclosed before trading, and when it issued statements heralding the promulgation of rule 14e-3, it failed to mention rule 10b-5 in this context.[105] This indicated to Judge Haight that the SEC assumed that a hole existed in the securities laws that was not already filled by rule 10b-5.[106]

Judge Haight examined numerous recent actions brought under rule 10b-5 which the Government argued constituted notice to Newman that the rule encompassed his particular conduct.[107] Most of these were complaints, consent decrees and a plea to an indictment.[108] Since they were "unlitigated," the district court decided that they lacked "precedential value"[109] and thus were legally insufficient as "clear and definite statement[s] of the conduct proscribed."[110]

The district court next reviewed the case law relied upon by the Government.[111] Because one group of proffered cases either adhered to a "traditional insider analysis"[112] or did not reach the issue of a non-insider's culpability under rule 10b-5,[113] the court decided they were inapposite to the theory of the instant indictment.[114] Judge Haight

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[102] *Id.* at 14-15.

[103] *Id.* at 15.

[104] *Id.* at 16.

[105] *Id.* at 17. An American Bar Association Comment Letter also influenced the court. The letter stated that "not every failure to disclose material information constitutes a violation of the anti-fraud rules. There remains the requirement that the non-disclosure either renders some other statement misleading or itself comprises part of an artifice or course of business operating as a fraud upon the other party in the transaction." ABA Comm. Letter on Material, Non-Public Information (Oct. 15, 1973), *reprinted in* SEC. REG. & L. REP. (BNA) (No. 233) D-1, at D-6 (Jan. 2, 1974).

[106] United States v. Courtois, No. S-81 Cr. 53, slip op. at 17 (S.D.N.Y. June 5, 1981), *rev'd sub nom.* United Stated v. Newman, 664 F.2d 12 (2d Cir. 1981).

[107] *Id.* at 18-19.

[108] *Id.* at 19.

[109] *Id.*

[110] *Id.* at 20.

[111] *Id.*

[112] *Id.* at 14, 20.

[113] *Id.* at 21.

[114] *Id.* at 20.

distinguished another group of cases which "treated 'misappropriation' as fraud" on the ground that they concerned theft of actual securities or their proceeds resulting in damage to the defrauded party in its capacity as an investor, whereas Newman's misappropriation injured the investment firms and their clients in their role as employers.[115] For these reasons, the district court concluded that when Newman traded on the basis of confidential market information, the securities laws did not mandate disclosure.[116] Consequently, Judge Haight dismissed the indictment with respect to rule 10b-5.[117]

With respect to the mail fraud charges, the district court based its dismissal of those counts in large part upon the Second Circuit's decision in *United States v. Von Barta*[118] which rejected the theory that the mail fraud statute is violated by any intentional breach of fiduciary honesty and loyalty on the part of an employee in furtherance of a scheme for pecuniary gain.[119] Judge Haight relied upon *United States v. Regent Office Supply Co.*,[120] which he said required the Government to prove that the defendant at least "contemplated" some actual harm or injury to the victim, though proof of actual injury was unnecessary.[121] Finally, the district court ruled that dismissal of the conspiracy charge "necessarily follow[ed]" dismissal of the substantive counts because criminal conspiracy could not be based upon noncriminal actions.[122]

In *United States v. Newman*, the Court of Appeals for the Second Circuit set out to resolve a question left unanswered by the Supreme Court in *Chiarella v. United States*.[123] The *Chiarella* Court declined to decide whether, in a securities transaction, a fiduciary duty to an employer created a duty to disclose confidential information obtained

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[115] *Id.* at 21-22. Judge Haight decided that the injury suffered by the investment firms and their clients as employers was properly redressed under state law. *Id.* at 22. The Supreme Court discussed the question whether state or federal law should control a given securities transaction in Santa Fe Indus. v. Green, 430 U.S. 462, 477-80 (1977). The Court made it abundantly clear that "a wide variety of corporate conduct [is] traditionally left to state regulation." *Id.* at 478. " 'Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.' " *Id.* at 479 (quoting Cort v. Ash, 422 U.S. 66, 84 (1975)).

[116] United States v. Courtois, No. 30-81 Cr. 53, slip op. at 24 (S.D.N.Y. June 5, 1981), *rev'd sub nom.* United States v. Newman, 664 F.2d 12 (2d Cir. 1981).

[117] *Id.*

[118] 635 F.2d 999 (2d Cir. 1980), *cert. denied*, 450 U.S. 998 (1981).

[119] *Id.* at 1002.

[120] 421 F.2d 1174 (2d Cir. 1970).

[121] United States v. Courtois, No. S-81 Cr. 53, slip op. at 28 (S.D.N.Y. June 5, 1981), *rev'd sub nom.* United States v. Newman, 664 F.2d 12 (2d Cir. 1981).

[122] *Id.* at 37.

[123] 664 F.2d at 15.

in the course of employment to a prospective purchaser or seller.[124] Judge Van Graafeiland, writing for the majority in *Newman*, answered that question in the affirmative and held that the alleged actions of these defendants were criminal under rule 10b-5 even though their employers were not "at the time . . . purchaser[s] or seller[s] of the target company securities in any transaction with any of the defendants."[125]

The court of appeals concentrated on two aspects of the lower court opinion in determining that Newman had notice that his behavior was subject to rule 10b-5 sanctions. Initially, the *Newman* court considered whether, under rule 10b-5, an actual purchaser or seller must be defrauded.[126] Then, the court examined whether the "misappropriation" was plainly the type of fraud which rule 10b-5 was intended to remedy.[127]

Judge Van Graafeiland scrutinized the language of the rule and remarked that it did not specifically require that fraud be perpetrated upon a buyer or seller of securities.[128] He noted, however, that courts have implied this requirement for the purpose of conferring standing to sue in private causes of action for damages.[129] Since this was a criminal case rather than a civil damage action, the court decided that a plaintiff's standing to sue was not relevant.[130] Therefore, Newman could not invoke this limitation to shield himself from rule 10b-5 liability.[131]

The *Newman* court thereafter focused on prior case law in exploring the confines of fraud under rule 10b-5.[132] Judge Van

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[124] 445 U.S. at 236-37.

[125] 664 F.2d at 16. Newman, Carniol and Spyropoulos were not investment firm employees but their liability derived from their aid, participation in, and facilitation of the violation of Courtois' and Antoniu's primary fiduciary duty. *Id.* The essence of that duty was the "honesty, loyalty and silence" owed directly to Morgan, Stanley, Kuhn, Loeb and their clients. *Id.*

[126] *Id.* at 17.

[127] *Id.* at 18.

[128] *Id.* at 17.

[129] *Id.* The court commented that:

> it is only because the judiciary has created a private cause of action for damages the 'contours' of which are not described in the statute, that standing in such cases has become a pivotal issue. The courts, not the Congress, have limited Rule 10b-5 suits for damages to the purchasers and sellers of securities.

Id. (citation omitted).

[130] *Id.*

[131] *Id.*

[132] *Id.* Judge Van Graafeiland alluded to Chief Justice Burger's dissent in *Chiarella* wherein he stated that the defendant " 'misappropriated—stole to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence.' " *Id.* (quoting 445 U.S. at 245 (Burger, C.J., dissenting)). The *Newman* court stated that these words "aptly describ[ed] the conduct of the connivers in the instant case." 664 F.2d at 17. Oddly, neither court considered the irony of the misappropriation theory in the context of 10b-5 disclose or abstain. It is somewhat illogical to

Graafeiland found that damage to an investment firm's reputation and the wrongful loss of its employees' honesty and loyalty resulting from the misappropriation of confidential information in order to make a securities transaction was essentially the same as a theft of an employer's cash or securities.[133] He also found that since misappropriation of confidential information by a fiduciary was consistently held to be unlawful in other areas of the law,[134] Newman should have known that his actions were proscribed by the "Securities Acts."[135]

The court then considered Newman's argument that his fraud was not linked to the buying or selling of securities within the meaning of rule 10b-5.[136] The *Newman* court invoked the broad "touch" test enunciated by the Supreme Court in *Superintendent of Insurance v. Banker's Life & Casualty*[137] which "construed the phrase 'in connection with' flexibly to include deceptive practices 'touching' the sale of securities."[138] The court decided that the fraud alleged in the indictment was sufficiently "in connection with" the purchase or sale of securities to satisfy the rule because Newman's only reason for misappropriating the secret information was to buy stocks in target companies.[139] In effect, Judge Van Graafeiland discounted the purchaser-seller requirement which the district court held was integral to fraudulent nondisclosure under rule 10b-5 and alternatively relied upon the indisputably deceptive nature of Newman's conduct. Based on this analysis, he concluded that the defendant had "clear notice" that his nondisclosure violated rule 10b-5.[140]

Turning to the lower court's dismissal of the mail fraud charges, the court of appeals stated that the district court had misconstrued its prior holdings involving employee misappropriation of confidential information and the use of the mails.[141] The *Newman* court distin-

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posit the fact that one who possesses information to which he has no right can create in another a right to possess it also.

[133] *Id.*

[134] *Id.* at 18.

[135] *Id.* Interestingly, the Second Circuit did *not* state that Newman should have known that his conduct was proscribed specifically by section 10(b) and rule 10b-5. This ignores the very point made by Judge Haight in the district court opinion that if Newman's conduct violated the federal securities laws at all, it violated section 14(e), not rule 10b-5. The Second Circuit failed to take into account the Supreme Court's ruling that not every breach of duty of a fiduciary is cognizable under section 10(b) and rule 10b-5. Santa Fe Indus. v. Green, 430 U.S. 462, 476 (1977).

[136] 664 F.2d at 18.

[137] 404 U.S. 6 (1971).

[138] 664 F.2d at 18 (quoting *Superintendent of Insurance*, 404 U.S. at 12). The court observed approvingly that even a "tenuous" connection between the deception and the securities would satisfy the test. *Id.* at 18.

[139] *Id.*

[140] *Id.* at 19.

[141] *Id.*

guished the case of *United States v. Von Barta*, relied upon by the district court, on its facts.[142] Moreover, it disagreed that prior circuit decisions mandated proof of "direct, tangible, economic loss to the victim, actual or contemplated" in cases involving an employee's breach of duty for mail fraud.[143] Instead, the *Newman* court adopted the more relaxed and recent standard of *United States v. Dorfman*[144] which merely required that a fiduciary use his position to garner secret profits in order to be prosecuted for mail fraud.[145] With respect to the conspiracy count, the court held that it must be reinstated along with the substantive counts.[146]

In reinstating Newman's indictment, the Court of Appeals for the Second Circuit expanded the scope of rule 10b-5, particularly in the context of disclose-or-abstain, beyond its established boundaries. It extended liability under the rule for reasons unrelated to the development of disclose-or-abstain in the first place, and in a manner contrary to its past application. The critical point in *Newman* was that the persons or entities to whom the defendant owed a fiduciary duty were not the same persons or entities with whom he traded securities. The lower court's opinion delineated the reasons why this connection was a necessary element of the offense.[147] By choosing to consider this as an issue of standing rather than as a substantive element of the offense, the *Newman* court missed a fundamental distinction.

The purchaser-seller requirement was imposed in civil damage actions to eliminate nuisance suits where a party purchasing securities then sues on a transaction completed beforehand.[148] This is unrelated to the existence of the purchaser-seller condition in disclose-or-abstain cases. It is present there because disclose-or-abstain was formulated to prevent insiders from profiting from their special knowlege when buying or selling securities. Thus, the abuses disclose-or-abstain was designed to prevent are specifically those which an insider could inflict upon a purchaser or seller.

The issue involved in *Newman* is not one of plaintiff's standing to sue but rather whether liability for failure to disclose under rule 10b-5

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[142] *Id. Von Barta* involved an employee who failed to disclose information to his employer. *Newman* involved an employee who fraudulently misappropriated information entrusted to his employer. *Id.*

[143] United States v. Courtois, No. S-81 Cr.53, slip op. at 37 (S.D.N.Y. June 5, 1981), *rev'd sub nom.* United States v. Newman, 664 F.2d 12 (2d Cir. 1981).

[144] 335 F. Supp. 675 (S.D.N.Y. 1971).

[145] *Id.* at 679.

[146] 664 F.2d at 20.

[147] See *supra* notes 90-115 and accompanying text.

[148] *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

can be found against a non-insider.[149] Although the precise question whether a duty to an employer could form the basis of a duty to disclose or abstain to a selling shareholder was not resolved by the Supreme Court in *Chiarella*,[150] the answer must be in the negative. An employee's fiduciary duty to his employer, of itself, has no logical connection with his duty to another party to a securities transaction. Additional support for this view may be found in Judge Dumbauld's concurring and dissenting opinion where he evinced doubts that the purchaser-seller requirement should be so easily dismissed and refused to take a postion on this issue.[151]

Further, the Second Circuit failed to consider the Supreme Court's careful admonition, relied upon by both the dissent in the Second Circuit's decision in *Chiarella* and the district court in dismissing Newman's indictment, that not all breaches of a fiduciary duty are fraud under rule 10b-5.[152] Instead, it virtually lumped all types of fraud together and placed them in the rule 10b-5 pot.[153] The court seemed to rely on the clear and unmistakable presence of a fraud, and equated it with the theoretical theft of a corporation or investor's tangible assets. As the district court pointed out, however, the prior cases based on misappropriation concerned situations which resulted in a direct deprivation to an *investor*. In the *Newman* case, the damage alleged in the indictment was to the employers as employers rather than as investors.[154]

Perhaps the Second Circuit was motivated by policy considerations[155] in *Newman* rather than by the law as it presently exists, but given the restrictive interpretation which the Supreme Court has accorded rule 10b-5 whenever it has considered it, *Newman* was decided inconsistently with the Court's evident preference to narrow the rule's scope.[156] One argument against extending rule 10b-5 liability to outsider defendants trading on non-inside information is that it

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[149] As previously noted, no precedent existed for this application. See *supra* notes 70-72 & 90-115 and accompanying text.

[150] 445 U.S. at 235-36.

[151] 664 F.2d at 20 (Dumbauld, J., concurring and dissenting).

[152] Santa Fe Indus. v. Green, 430 U.S. 462, 472 (1977).

[153] See *supra* notes 132-35 and accompanying text.

[154] United States v. Courtois, No. S-81 Cr.53, slip op. at 21 (S.D.N.Y. June 5, 1981), *rev'd sub nom.* United States v. Newman, 664 F.2d 12 (2d Cir. 1981).

[155] Judge Meskill indicated that policy considerations were the impetus behind the Second Circuit's affirmance of Chiarella's conviction. United States v. Chiarella, 588 F.2d at 1373 (Meskill, J., dissenting).

[156] *See* Santa Fe Indus. v. Green, 430 U.S. 462 (1977) (breach of fiduciary duty by majority shareholder must be in nature of manipulative or deceptive act for rule 10b-5 to apply); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (negligence alone not sufficient to establish liability

will open a Pandora's box of activities which would then come within the rule. These activities might include judges' clerks trading with knowledge derived from as yet unpublished opinions and Federal Reserve Bank employees trading on advance information about changed margin rates.[157] One who fortuitously witnesses a factory burn down, or a union member who knows that a strike is imminent and acts upon this knowledge[158] may come within the scope of the *Newman* rule. Although these situations are manifestly beyond the intended scope of section 10(b) and rule 10b-5 the logical extension of the *Newman* court's rationale would embrace such activity nevertheless.

An ever broadening area of rule 10b-5 liability must eventually result in a rule which is no rule at all. Given the fact that Newman was properly chargeable for his fraudulent conduct under state law[159] and that there was no obstacle to his prosecution for mail fraud,[160] his indictment under section 10(b) and rule 10b-5 was unnecessary as well as improper.

The ultimate result of the Second Circuit's anomalous decision in *Newman* is that persons never before vulnerable under the securities acts are now criminally liable without explicit authorization by con-

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under rule 10b-5); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (plaintiff must be actual purchaser or seller in order to prosecute private damage action under rule 10b-5).

[157] Note, *One With Regular Access to Market Information Violates Rule 10b-5 When Trading in Securities Without Disclosing that Information*, 10 SETON HALL L. REV. 720, 737 n.113 (1980).

[158] Block & Prussin, *'Outsider' Duties in Insider Trading*, Nat'l L.J., Dec. 28, 1981, at 21, col. 4.

[159] N.Y. BUS. CORP. LAW § 1611 (McKinney Cum. Supp. 1981-1982).

[160] In 1954, the Supreme Court decided Pereira v. United States, 347 U.S. 1 (1954). It there held that the federal mail fraud statute, 18 U.S.C. § 1341 (1976), consisted of two elements: 1) a scheme to defraud, and 2) use of the mails for the purpose of executing the scheme. 347 U.S. 1, 8 (1954). It was unnecessary that use of the mails be an essential part of the scheme. *Id.* One who acted with knowledge that use of the mails would follow in the ordinary course of business, or who could reasonably foresee such use whether he intended it or not, caused the mails to be used within the meaning of the statute. *Id.* at 8-9. In Newman's case, federal jurisdiction was presumably invoked under the mail fraud statute on the basis of slips mailed to the defendants to confirm their transactions or some similar use of the mails. For a discussion of this principle see Note, *Nontraditional Corporate Insiders in Possession of Material Inside Information Have a Duty Either to Disclose the Inside Information or to Abstain from Trading in the Corporation's Stock*, 47 GEO. WASH. L. REV. 965, 966 n.2 (1979). Thus, regardless of who did the mailing, the very fact that the mail system was used placed Newman and the others within the purview of the mail fraud statute. That rule 10b-5 may not be properly operable here poses no problem. Clearly, the indictment charged the defendants with a scheme to defraud, whether or not it was such fraud as rule 10b-5 was intended to cover. The mail fraud statute has been called a "first line of defense" against ingenious frauds which escape specific statutory prohibition. United States v. Kelly, 507 F. Supp. 495, 498 (E.D. Pa. 1981); *see also* United States v. Reece, 614 F.2d 1259 (10th Cir. 1980). In each of these cases, economic harm allegedly had resulted to the

gressional legislation. Moreover, given that one of the primary purposes of rule 10b-5 is to protect investors,[161] this application of disclose-or-abstain does not effectuate that intended purpose. An unfortunate precedent has been set which allows rule 10b-5 to be molded by the Government or the SEC to fit almost any fact pattern that includes a securities transaction on the one hand and a breached fiduciary duty on the other.

In the future, the courts will be faced with a variety of novel situations where the *Newman* construction of rule 10b-5 might apply. The *Newman* decision provides little guidance while prior case law and the rule itself, in the context of corporate outsiders, provided none at all. The SEC by amending and clarifying rule 10b-5, or Congress by appropriate legislation, should eliminate this inevitable confusion and settle the question in the proper forum.

Jacqueline Grindrod

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employer; in *Kelly*, however, that apparently was not considered a necessary element of the crime.

The Court of Appeals for the Second Circuit noted in United States v. Von Barta, 635 F.2d 999 (2d Cir. 1980), *cert. denied*, 450 U.S. 998 (1981), that varying approaches to interpreting the mail fraud statute had been taken in different jurisdictions. *Id.* at 1005. It chose to rest its decision that the statute applied on "special circumstances," specifically, Von Barta's experience, his employer's request that he advise the employer of adverse developments, and Von Barta's position of "great trust" and considerable power. *Id.* at 1007. These circumstances were the source of Von Barta's duty to disclose. Prior to that decision was United States v. Dorfman, 335 F. Supp. 675 (S.D.N.Y. 1971). That case held that breach of trust of a fiduciary using his position to make secret profits was fraud within the meaning of the mail fraud statute and that actually obtaining money from the victim was unnecessary. *Id.* This case buttressed the *Newman* court's decision to reinstate the mail fraud charges. *See* 664 F.2d at 20.

[161] 15 U.S.C. § 78j (1976); *see also* Desser v. Ashton, 408 F. Supp. 1174, 1176 (S.D.N.Y. 1975), *aff'd*, 573 F.2d 1289 (2d Cir. 1977); United Sportfishers v. Buffo, 396 F. Supp. 310, 312 (S.D. Cal. 1975), *aff'd*, 597 F.2d 658 (9th Cir. 1978).