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TRADING ON CONFIDENTIAL INFORMATION—CHIARELLA TAKES AN ENCORE: UNITED STATES v. NEWMAN

Rule 10b-5, promulgated pursuant to section 10(b) of the Securities Exchange Act of 1934, prohibits fraud in connection with the purchase or sale of securities. Because the rule is broadly drawn, and has been interpreted to encompass a wide variety of novel or atypical schemes, the extent of its proscriptions has been the subject of much litigation. In Chiarella v. United States, for instance, the Supreme Court considered whether a market insider,

3 Rule 10b-5 provides:
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
6 Rule 10b-5 has been the most extensively litigated securities regulation. SEC v. National Sec., Inc., 393 U.S. 453, 465 (1969).
8 The term "market insider" refers to one who has access to market information by virtue of his strategic position in an entity which plays a key role in market transactions, such as a law firm, bank, investment banking company, or financial printing company. United States v. Chiarella, 588 F.2d 1358, 1365 (2d Cir. 1978), rev'd, 445 U.S. 222 (1980).
who had traded on confidential information concerning impending tender offers, was criminally liable for such conduct under rule 10b-5. The Court held that liability could not be premised upon a mere failure to disclose material nonpublic information, absent the existence of a duty to disclose arising from a relationship of trust and confidence. The Court declined to decide a related proposition, namely, whether an employee owes to his employer a duty, under rule 10b-5, not to misappropriate confidential information. Nonetheless, in United States v. Newman, the United States Court of Appeals for the Second Circuit recently concluded, on facts analogous to those in Chiarella, that a criminal violation of rule 10b-5 may be established by a breach of an agent's duty to respect client confidences.

9 445 U.S. at 224. The defendant, Chiarella, was employed as a "markup man" by Pandick Press, a financial printing house. Id. In the course of his duties, he was afforded access to various documents relating to corporate takeovers. Id. Although the true names of the companies involved were disguised in order to preserve confidentiality, on five occasions Chiarella was able to detect the names of target companies, purchase stock in them prior to public announcement of the takeovers, and sell his shares at a profit. Id. An SEC investigation uncovered Chiarella's activities, and resulted in a consent decree requiring Chiarella to make restitution to the sellers of the stock. Id. Subsequently, he was indicted and convicted for willful violation of rule 10b-5. Id. at 225. The Second Circuit affirmed the conviction, holding that Chiarella was a "market insider," that is, someone who had regular access to material nonpublic information and thereby incurred a duty to disclose or to refrain from trading. United States v. Chiarella, 588 F.2d 1358, 1365-66 (2d Cir. 1978), rev'd, 445 U.S. 222 (1980).

In a 6-to-3 decision, the Supreme Court reversed the conviction, rejecting the "market insider" approach. The Court held that the mere possession of material nonpublic information did not give rise to a duty to disclose. 445 U.S. at 229. Rather, the imposition of liability under rule 10b-5 for nondisclosure depends upon "a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." Id. at 230. Since there was no fiduciary relationship between Chiarella and the sellers of the target companies' securities, the Court concluded that Chiarella did not violate rule 10b-5 by trading. Id. at 231.

10 445 U.S. at 227. The Supreme Court found that Chiarella was not in a relationship of trust or confidence with the sellers of the target companies' securities which would give rise to a duty to disclose, and therefore his silence was not fraudulent. Id. at 232. The Court noted that Chiarella "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.

11 Id. at 235-37.
12 664 F.2d 12 (2d Cir. 1981).
14 664 F.2d at 16.
The indictment in *Newman* alleged a scheme among five persons: Antoniu and Courtois, employees of two prominent Wall Street investment banking companies; Newman, a securities trader and manager of the over-the-counter trading department of a New York brokerage firm; and two other persons, Carniol and Spyropoulos. The government charged that, between 1973 and 1978, Antoniu and Courtois misappropriated, from their respective employers, confidential, nonpublic information concerning impending takeovers and acquisitions, and secretly conveyed this information to Newman, Carniol, and Spyropoulos. Using secret foreign bank accounts and Bahamian trust accounts, Newman and the others arranged to purchase stock in the prospective target companies. Once the takeover plans were made public, and the price of the stock had risen, the stock was sold, and the profits shared among the coconspirators.

As in *Chiarella*, the Department of Justice alleged that the defendants' conduct in misappropriating and trading on confidential information constituted criminal violations of section 10(b) and rule 10b-5. Rather than charging the defendants with a fail-

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15 The indictment named four of the five alleged coconspirators as defendants: James Mitchell Newman, E. Jacques Courtois, Jr., Franklin Carniol, and Constantine Spyropoulos. *Id.* at 14-15. Newman was the only party within the jurisdiction of the district court and thus was the only party to the district court proceedings. *Id.* at 15. Courtois, Carniol, and Spyropoulos left the United States, and were, at the time of the indictment, the subjects of extradition attempts by the government. [1981] FED. SEC. L. REP. (CCH) ¶ 98,024, at 91,287 n.1. The Second Circuit observed, however, that the allegations of the indictment referred to all of the defendants. 664 F.2d at 15.

The fifth coconspirator, Adrian Antoniu, was not indicted. *Id.* He chose to cooperate with the government and plead guilty to two counts of an information charging him with securities fraud in violation of rule 10b-5. United States v. Newman, 664 F.2d 12, app. at A35-54 (2d Cir. 1981).

16 Antoniu and Courtois were employed by the investment banking firms of Morgan Stanley & Co., Inc. (Morgan Stanley) and Kuhn Loeb & Co. (Kuhn Loeb). 664 F.2d at 15.


18 Carniol, a resident of Belgium, purportedly used secret Luxembourg bank accounts to trade on the information Antoniu leaked to him. *Id.* at 5. Spyropoulos, a Greek citizen living in Greece and France, apparently used Swiss bank accounts to avoid detection. *Id.; see* 664 F.2d at 15.

19 664 F.2d at 15.

20 *Id.*

21 *Id.* The indictment did not indicate the amount of money involved in the transactions or the amount of profits that the defendants had realized. In its brief, however, the government represented that Antoniu and the defendants "reaped profits conservatively estimated at hundreds of thousands of dollars." Brief for United States at 7, United States v. Newman, 664 F.2d 12 (2d Cir. 1981).

22 664 F.2d at 15-16.
ure to disclose, however, the government alleged that the gravamen of the violation was the fraud which had been perpetrated through Antoniu's and Courtois' breach of the fiduciary duties owed to their employers, their employers' corporate clients, and the clients' shareholders.

On Newman's motion, the district court dismissed all counts of the indictment as to Newman, based upon its conclusion that Newman had not received adequate notice that his allegedly criminal activities fell within the ambit of rule 10b-5's proscriptions. Judge Haight, authoring the Newman district court opinion, reasoned that, at the time of the defendants' activities, there was no clear indication in the law that rule 10b-5 extended to a non-insider's violation of a fiduciary duty owed to an acquiring corporation in a tender offer.

23 The indictment alleged that Antoniu and Courtois owed the fiduciary duties of "honesty, loyalty and silence," and more specifically, the duty to "maintain the confidentiality of material, confidential information provided to them in trust and confidence by their employers and their employers' clients." Indictment at ¶ 10(c), No. S81 Cr. 53 (S.D.N.Y. 1981). The indictment charged that they affirmatively misled their employers by, inter alia, failing to report the buyers' trading to their employers as required and by "falsely and fraudulently" asserting that they maintained no direct or indirect interest in securities trading accounts. Id.

24 Id. Since the indictment was based on Antoniu's and Courtois' breach of the fiduciary duties stemming from their employee status, the liability of the other defendants was predicated upon the theories of conspiracy under 18 U.S.C. § 371 (1976) and aiding and abetting under 18 U.S.C. § 2 (1976). [1981] Fed. Sec. L. Rep. (CCH) ¶ 98,024, at 91,288. In addition to the rule 10b-5 violations, the indictment charged the defendant with 13 counts of mail fraud, under 18 U.S.C. § 1341 (1976), as well as one separate count of conspiracy to violate the mail fraud statute and rule 10b-5. [1981] Fed. Sec. L. Rep. (CCH) ¶ 98,024, at 91,288.


26 Id. at 91,296. In order to satisfy the fifth amendment due process guarantee of "notice," a criminal statute or regulation such as rule 10b-5 must sufficiently "afford fair warning to persons prosecuted under the statute that the conduct for which they could be convicted had been a crime." United States v. Pray, 452 F. Supp. 788, 796 (M.D. Pa. 1978). Section 10(b) and rule 10b-5 have withstood the challenge that they are so broad and ambiguous as to be unconstitutionally vague per se. See Todd & Co. v. SEC, 557 F.2d 1008, 1013 (3d Cir. 1977); United States v. Persky, 520 F.2d 283, 287-88 (2d Cir. 1975); United States v. Pray, 452 F. Supp. at 796. But see United States v. Chiarella, 588 F.2d 1358, 1377 (2d Cir. 1980) (Meskill, J., dissenting). A particular interpretation of the statute, however, may be unconstitutional, because "some courses of conduct may be so close to the perimeter of the acts proscribed by [section 10(b)] and Rule 10b-5 that it would be unconstitutional to prosecute persons committing those acts." United States v. Pray, 452 F. Supp. at 796. Judge Meskill, dissenting in Chiarella, maintained that "the 'clear and definite statement of the conduct proscribed' to which . . . a defendant is entitled, must emanate from the language of the statute itself, from prior judicial interpretation, or from established custom and usage." 588 F.2d at 1377 (Meskill, J., dissenting).

On appeal, the Second Circuit reversed, holding that the indictment charged an actionable violation of rule 10b-5. Writing for a panel divided on the rule 10b-5 issue, Judge Van Graafeiland expressly adopted the theory left open by Chiarella, and found that a violation of an employee's duty to respect client confidences gave rise to a transgression of rule 10b-5 when the employee traded on the converted information. Judge Van Graafeiland then turned to consider, and reject, three limitations on rule 10b-5 liability: the purchaser-seller limitation, the fraud or deceit requirement, and the "in connection with the purchase or sale of securities" requirement.


28 664 F.2d at 16, 20.

The panel consisted of Circuit Judges Van Graafeiland and Newman, and District Judge Dumbauld of the Western District of Pennsylvania, sitting by designation. Judge Dumbauld filed a separate opinion concurring in the reversal of the mail fraud counts and dissenting as to reversal of the dismissal of the rule 10b-5 counts. In his dissent, Judge Dumbauld explained that in view of the recent Supreme Court trend to confine section 10(b) "to practices harmful to participants in actual purchase-sale transactions," he preferred to uphold the indictment on the "more solid ground" that the defendants' conduct had clearly violated the mail fraud statute. Id. at 20-21 (Dumbauld, J., concurring and dissenting) (citing Chiarella v. United States, 445 U.S. 222 (1980); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)).

30 The "breach of fiduciary duty" theory also was used to uphold the mail fraud indictment. 664 F.2d at 19-20. Relying upon two of its recent holdings, United States v. Bronston, 658 F.2d 920 (2d Cir. 1981) and United States v. Von Barta, 635 F.2d 999 (2d Cir. 1980), cert. denied, 101 S. Ct. 1703 (1981), the court reaffirmed that a mail fraud violation could be established when there is "'concealment by a fiduciary of material information which he is under a duty to disclose to another under circumstances where the non-disclosure could or does result in harm to another.'" 664 F.2d at 19 (quoting United States v. Bronston, 658 F.2d 920, 926 (2d Cir. 1981)).

The court also rejected the lower court's holding that a mail fraud indictment based upon an employee's breach of fiduciary duty requires proof of "'direct, tangible, economic loss to the victim, actual or contemplated.'" 664 F.2d at 20. Even if such proof were required, however, the court believed that it could be satisfied by the diminution in the value of the confidential information caused by a loss of the secrecy surrounding impending tender offers. Id.; see Abbott v. United States, 239 F.2d 310, 314 (3d Cir. 1956). The court indicated that the misappropriation of confidential information would be almost inherently prejudicial to the investment companies and their clients in the case of a contemplated undisclosed tender offer. See 664 F.2d at 20.

31 See 664 F.2d at 16. Judge Van Graafeiland apparently espoused the alternative theory espounded by Chief Judge Kaufman in the Second Circuit's Chiarella opinion. See id. He noted that Judge Kaufman had declared that a "'violation of an agent's duty to respect client confidences was a clear transgression of Rule 10b-5 'where, as here, the converted information both concerned securities and was used to purchase and sell securities.'" Id. (quoting United States v. Chiarella, 588 F.2d at 1368 n.14).

The court first addressed the question of whether the fraud must be perpetrated upon the actual seller or buyer of securities in order to impose criminal liability under rule 10b-5, and concluded that no such requirement existed. Judge Van Graafeiland reasoned that this limitation is merely a judicially engrafted standing requirement, applicable only to the implied private right of action for damages under rule 10b-5. With respect to suits for injunctive relief, however, the Newman court observed that several courts had held that a plaintiff need not be a defrauded purchaser or seller in order to be able to sue under the rule. Thus, the court concluded, the refusal of courts to imply such a standing requirement in injunctive suits should reasonably have alerted the defendant to the possibility that courts would similarly opt to adhere to the express language of rule 10b-5 in a criminal suit.

With respect to the second limitation on the application of the rule—the fraud or deceit requirement—the Newman court concluded that the defendants' misappropriation of confidential information clearly constituted a fraud upon their employers and upon their employers' clients. Finally, addressing the "in conne-

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33 664 F.2d at 17.
36 664 F.2d at 17. Judge Van Graafeiland stated that because suits for injunctive relief do not incorporate the purchaser-seller requirement, the "appellee reasonably should have anticipated that in a criminal action the courts likewise would follow the language of the Rule." Id. The court of appeals found, therefore, that the defendants had sufficient forewarning of the scope of the rule they were charged with violating.
37 Id. The court stated that because the defendants "misappropriated—stole to put it bluntly" valuable confidential information, their conduct unquestionably constituted a fraud on Antoniu's and Courtois' employers and their clients. Id. (quoting Chiarella v. United States, 445 U.S. 222, 238 n. (1980) (Burger, C.J., dissenting)).
38 664 F.2d at 17. The court stated that "[b]y sullying the reputations of Courtois' and Antoniu's employers as safe repositories of client confidences," Newman and his codefendants had defrauded Morgan Stanley and Kuhn Loeb "as surely as if they took their money." Id.
39 Id. The court viewed the fraud on Morgan Stanley's and Kuhn Loeb's clients as the artificial inflation of the target company stock prices when the clients' takeover plans had been "keyed to target company stock prices fixed by market forces." Id.
tion with” limitation, the *Newman* court noted that this phrase had been flexibly construed to encompass deceptive practices “touching” the sale of securities.\(^4^0\) Since the sole purpose of the fraud in the instant case was to purchase shares of the target companies, the court concluded that this nexus satisfied the “very tenuous” relationship required.\(^4^1\)

The expansive interpretation of rule 10b-5 articulated in the *Newman* decision is possessed of several advantages. By holding that a breach of an agent’s fiduciary duty constitutes an actionable violation of the rule, the Second Circuit effectively added a new weapon to the SEC’s antifraud arsenal, thereby enabling it to police insider activities which otherwise would be unreachable under *Chiarella*.\(^4^2\) Additionally, since *Newman* raises the specter of a po-


\(^4^1\) 664 F.2d at 18 (quoting 1 A. Bromberg & L. Lowenfels, *Securities Fraud and Commodities Fraud* § 4.7(574)(3), at 88.34 (1979)).


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 a tender offer which information he knows or has reason to know is non-public 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
tential criminal prosecution, with its attendant scandal, it is suggested that employers engaged in servicing securities trading will exert greater vigilance, adopt more sophisticated precautions, and issue sterner warnings to their employees regarding confidential information. Similarly, the decision may serve as a deterrent to members of the securities trading community tempted by easy access to potentially lucrative information. Indeed, the image of more rigorous enforcement may serve to assuage the fears of the investing public, whose faith in the integrity of the securities market has been shaken by extensive publicity to the effect that the

or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities . . . unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.


The Newman decision, however, is still of great significance because of its establishment of the “fiduciary duty” principle under rule 10b-5. Since the application of rule 14e-3 is confined to the tender offer area, the Newman case is important because it articulates a potential theory of liability under rule 10b-5, analogous to that created in rule 14e-3, for wrongful conduct relating to other significant corporate transactions, such as mergers and negotiated acquisitions. Brief for SEC at 4, United States v. Newman, 664 F.2d 12 (2d Cir. 1981) (amicus curiae).

Interestingly, precautions had been taken by both Pandick Press, the financial printing company that employed Chiarella, and by Morgan Stanley and Kuhn Loeb, the investment banking companies in the Newman case. The Chiarella case revealed that Pandick Press had posted throughout the shop and above the time clock large boldface signs which advised employees that confidential information was the property of the customer, forbade them to use the information for their own or anyone else’s benefit, warned them that violation of this rule would subject them to immediate dismissal and potential criminal penalties, and required them to report any violations to their employer. United States v. Chiarella, 588 F.2d 1358, 1369 (2d Cir. 1978), rev’d, 445 U.S. 22 (1980). In Newman, the Kuhn Loeb and Morgan Stanley employees were required to pledge that they would maintain the confidentiality of the material entrusted to them, and to maintain no direct or indirect interest in securities trading accounts. Indictment at ¶ 10(c), United States v. Newman, No. S81 Cr. 53 (S.D.N.Y. 1981).

The use of criminal penalties to administer the securities laws raises the larger issue of the function of criminal sanctions in the enforcement of economic regulatory legislation. While some argue that it is unjust to send a violator to jail for an illegal but generally known business practice, Ball & Friedman, The Use of Criminal Sanctions in the Enforcement of Economic Legislation: A Sociological View, 17 Stan. L. Rev. 197, 198 (1965), sociologists generally believe that fear of criminal prosecution acts as an effective deterrent to businessmen, professional men, and the middle class, id. at 216. In view of such deterrent effect, Professors Ball and Friedman have concluded that criminal sanctions should also be highly effective in patrolling economic crimes. Id. Additionally, the threat of criminal prosecution may make noncriminal sanctions more effective. Id. See generally Kadish, Some Observations on the Use of Criminal Sanctions in Enforcing Economic Regulations, 30 U. Chi. L. Rev. 423, 426 (1963).
market is riddled with insider trading.\textsuperscript{45}

Notwithstanding such practical benefits, it is submitted that the \textit{Newman} decision is more significant than the court of appeals acknowledges.\textsuperscript{46} By permitting the misappropriation of information from acquiring companies to fulfill the fraud requirement of a rule 10b-5 violation, the Second Circuit has transformed an employee's fiduciary obligations into the status of a new federal securities law duty.\textsuperscript{47} Antoniu and Courtois unquestionably owed certain fiduciary obligations.\textsuperscript{48} See \textit{SEC Chief Seeking to Reassure Investors, Says Insider-Trading Cases are Limited}, Wall St. J., Nov. 17, 1981, at 10, col. 2. While the SEC had for some time publicized its battles against insider trading, it was forced, by November 1981, to reassure investors that insider trading affected "only a tiny fraction of the total volume of securities."\textsuperscript{11} Id. (statement of SEC Chairman John Shad). \textit{But see} 46 SEC ANN. REP. xi (1980) (concentrated enforcement in the area of insider trading is "critical to the integrity of public securities market").

\textsuperscript{46} While the \textit{Newman} court phrased its opinion in terms of simply meeting the normal requirements of a rule 10b-5 violation, see \textit{United States v. Newman}, 664 F.2d 12, 16-19 (2d Cir. 1981), the ground-breaking impact of the decision is that it is the first case to recognize the novel theory of rule 10b-5 liability based upon a defendant's breach of fiduciary duties in misappropriating information—the theory left open by \textit{Chiarella}. See \textit{Langevoort, Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement}, 70 CALIF. L. REV. 1, 49 (1982).

\textsuperscript{47} Rule 10b-5 does not expressly address liability for nondisclosure of nonpublic information. See note 3 supra. Rather, the concept of a duty to disclose under the rule is the result of judicial and administrative interpretation. See \textit{Langevoort, supra} note 46, at 3; Note, \textit{Rule 10b-5 and the Duty to Disclose Market Information: It Takes A Thief}, 55 S. JOURN'S L. Rsv. 93, 94 (1980). In construing rule 10b-5, early courts made reference to common-law principles of fraud and deceit, and imposed liability for silence when there was a fiduciary relationship between the parties giving rise to a "duty" to disclose. See \textit{Trussell v. United Underwriters, Ltd.}, 228 F. Supp. 757, 774 (D. Colo. 1964); \textit{Tobacco & Allied Stocks, Inc. v. Transamerica Corp.}, 143 F. Supp. 323, 331 (D. Del. 1956), aff'd, 244 F.2d 902 (3d Cir. 1957). The SEC and the courts extended the duty to insiders and tippees of insiders. See \textit{Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.}, 495 F.2d 228, 235-36 (2d Cir. 1974); \textit{In re Cady, Roberts & Co.}, 40 S.E.C. 907 (1961). As the unfairness element of the cases became more pronounced, see, e.g., \textit{SEC v. Texas Gulf Sulphur Co.}, 401 F.2d 333, 861-62 (2d Cir. 1968) (en banc), \textit{cert. denied}, 394 U.S. 976 (1969), it appeared that the trend of expansion might culminate in a rule 10b-5 duty to disclose whenever a party possessed material inside information, premised upon a duty owed to the investing public. See Note, \textit{Rule 10b-5 and the Duty to Disclose Market Information: It Takes A Thief}, supra, at 108-09. The \textit{Chiarella} Court rejected such a generalized duty, holding that \textit{Chiarella} owed no duty to the sellers from whom he purchased his stock because he was not in a fiduciary relation with them. \textit{Chiarella v. United States}, 445 U.S. 222, 227, 232-33 (1980). Justice Stevens noted, however, that \textit{Chiarella} owed a duty to the tender offerors and his employer. \textit{Id. at} 238 (Stevens, J., concurring). Because disclosure would be detrimental to those to whom he owed a duty of loyalty, this duty could not be fashioned in terms of a "disclose or refrain from trading" rule, but rather had to be labelled a "duty of silence." \textit{Id.} (Stevens, J., concurring). Justice Stevens suggested that breach of this duty might bring \textit{Chiarella} within rule 10b-5, but declined to decide whether such a securities duty should be recognized. \textit{Id.} (Stevens, J., concurring).
ary duties with respect to the information entrusted them by virtue of their positions as agents of the investment banking firms, and subagents vis-a-vis the tender offerors. They, therefore, were prohibited from engaging in self-dealing, from placing themselves in a position of conflict of interest, and from using for their own advantage any of their principals' confidential information. Concededly, the scheme alleged in the Newman indictment contravenes those common-law principles of agency duties. Nonetheless, the propriety of the court's elevation of the breach of such duties into a securities fraud is questionable. In this regard, the courts generally have recognized that the reason for rule 10b-5 liability is the "inherent unfairness involved where a party takes advantage of [nonpublic] information knowing it is unavailable to those with whom he is dealing." Thus, nondisclosure is penalized in order to forestall overreaching in securities transactions. The Newman court, however, in a theoretical move akin to applying the concept of transferred intent and accomplished by a broad use of

48 United States v. Newman, 664 F.2d at 16; see Chiarella v. United States, 446 U.S. at 237. Having assumed to act under the control and for the benefit of its clients, Kuhn Loeb and Morgan Stanley became the agents of the offering companies. See Restatement (Second) of Agency § 14 (1958). Antoniu and Courtois, as trusted employees, were agents of the investment banking companies, and thus were subagents with respect to the tender offerors. See W. Seavey, Agency 10 (1964).

49 See Restatement of Agency §§ 388, 390, 393, 395 (1933).


51 Determining whether the fraud falls within the contemplated scope of rule 10b-5 is a dual-edged problem which may be couched either in terms of the substance of the "fraud" or the "remoteness" of the security purchase. Courts have used both approaches to the same end—to find the limits of liability under rule 10b-5. Compare O'Brien v. Continental Ill. Nat'l Bank & Trust Co., 593 F.2d 54, 63 (7th Cir. 1979) (breach of fiduciary or contractual duties to investors does not rise to the level of a section 10(b) fraud) with Wilson v. First Houston Inv. Corp., 566 F.2d 1235, 1243 (5th Cir. 1978) (the purchase and sale of securities was too remote to bring wrongdoing within section 10(b)). At issue in both instances is the reach of section 10(b) and rule 10b-5.


54 Under principles of tort law, if A harms B by an act intended for C, A may be held liable for an intentional tort to B under the theory of transferred intent; the doctrine permits the intent to harm one party to fulfill the intent to harm the person actually harmed.
the "in connection with" requirement, permitted the wrongdoing in the misappropriation of the confidential information to substitute for the fraud in failing to disclose. The rationale of preventing overreaching was thus abandoned; yet the violation committed by the defendants remains the same as in Chiarella—the purchase of target company shares prior to public announcement of a tender offer. Thus, it is suggested that the court's characterization of the defendants' conduct as "fraud" is merely a means of circumventing the Chiarella holding, but without the traditional rationale for rule 10b-5 liability.

See Talmage v. Smith, 101 Mich. 370, 373-74, 59 N.W. 656, 657 (1894); Carnes v. Thompson, 48 S.W.2d 903, 904 (Mo. 1932). See generally Prosser, Transferred Intent, 45 Tex. L. Rev. 650 (1967). In Newman, in order to fulfill the fraud theory and the underlying duty requirement of Chiarella, the court substituted "fraud on the source" of the information for fraud on the investor. See Langevoort, supra note 46, at 46.

See note 54 supra. The district court, in Newman, held that this substitution brought the fraud outside of rule 10b-5, because it was not perpetrated on the employers and the acquiring companies in their capacities as investors. United States v. Courttois, [1981] Fed. Sec. L. Rep. ¶ 98,024, at 91,296; accord, O'Brien v. Continental Ill. Nat'l Bank & Trust Co., 593 F.2d 54, 59 (7th Cir. 1979). In O'Brien, the plaintiffs, trustees of union and employee pension trust funds, alleged a rule 10b-5 fraud by the defendant bank to whom these funds were turned over for investment. 593 F.2d at 57. The bank, acting as agent and trustee, hence assuming a fiduciary duty of due care, bought and sold stock for the benefit of the trusts. Id. The plaintiffs alleged, inter alia, that the bank engaged in self-dealing for its own benefit by purchasing securities issued by companies of which they were substantial creditors without disclosing its conflict of interest or its adverse inside information. Id. In finding that the breach of fiduciary duties did not constitute a rule 10b-5 violation, the court noted that the "[p]laintiffs . . . could not and did not allege that they were induced to buy or sell securities by the nondisclosures." Id. at 58. Rather, they "were induced not to exercise their respective powers to terminate the . . . contractual relationships with [the bank]." Id. But see Branson, Discourse on the Supreme Court Approach to SEC Rule 10b-5 and Insider Trading, 30 Emory L.J. 263, 301-03 (1981) (substitution of misappropriation theory in place of pre-Chiarella duty to the marketplace may be the first step in reworking and rethinking "the present nearly unintelligible, conceptually slippery, and counterproductive insider trading enforcement scheme").

See note 9 supra.

Since both the tender offeror and the defendants possessed the same knowledge of the significant upcoming corporate event, the defendants' conduct was not overreaching with respect to the acquiring companies. The SEC has maintained that, despite this distinction and despite the Chiarella holding that such persons owed no duty to the sellers of the target company stock or to the marketplace, Newman-type practices fall within the general policy concerns of rule 10b-5 because "such conduct undermines the integrity of, and investor confidence in, the securities markets." SEC Release No. 17,120 (Sept. 4, 1980). In opposition to this policy basis for broad regulation of insider trading are the exponents of an economic approach to the use of undisclosed material information in securities markets. See Heller, Chiarella, SEC Rule 14e-3 and Dirks: "Fairness" versus Economic Theory, 37 Bus. Law. 517, 517 (1982). Economists have developed a capital market theory known as the "Efficient Capital Market Hypothesis" (ECMH) which posits that insider trading increases the flow of information to the market and thus improves market efficiency, and its ability to
The *Newman* court's labelling of the defendants' conduct as securities fraud under rule 10b-5 suffers from an additional conceptual flaw. In order to bring the defendants' activities within the scope of rule 10b-5, the court suggested that a rise in the value of a target company's stock, precipitated by the defendant's trading, could work to defraud the tender offeror by endangering its takeover plans.68 This formulation of fraud, however, presumes a vested interest in the target company which merits protection by rule 10b-5.69 It further presumes a right to confidentiality concerning corporate activities that is shielded by rule 10b-5.69 Yet, it is far from clear that an acquiring company has a protected interest in the target of an incipient unannounced tender offer.61 Moreover,
rule 10b-5 protection has not been extended so broadly that the harm it prohibits may consist of an indirect disturbance of the natural securities market. The *Newman* court's description of the legislative history of tender offer provisions of the Williams Act, the Court noted testimony describing takeover bidders as “corporate raiders” and “takeover pirates,” *id.* at 28, and emphasizing that the tender offeror has “the resources and the arsenal of moves and countermoves which adequately protect their interests,” *id.* at 29. *See also* *Hearings on S. 510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency,* 90th Cong., 1st Sess. 42-43 (1967) (statement of Sen. Kuchel). The *Piper* Court concluded that these remarks, along with other substantial indicia, indicated that Congress' primary concern in drafting the legislation was the protection of investors, not tender offerors. 430 U.S. at 29-30. Therefore, the Court refused to imply a cause of action for the unsuccessful tender offeror under section 14(e). *Id.* at 35. Moreover, in a related context, the interests of the tender offeror have been deemed not worthy of protection. The management of the target company of a hostile tender offer frequently will attempt to fend off the bidder by seeking the aid of a more acceptable company, known as a “white knight,” who will meet or better the tender offeror's bid. Bloomenthal, *The New Tender Offer Regimen, State Regulation, and Preemption,* 30 Emory L.J. 35, 36 (1981). Once a white knight enters the picture, the competing offerors may engage in a bidding war, driving the premium price of the bids upward, or perhaps causing the withdrawal of the original bid. *Id.* at 45. Absent actual market manipulation and collusion, the purchases and bidding of the white knight do not violate SEC rules. *See* Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 794-96 (2d Cir. 1969). Indeed, the SEC rules contemplate that there may be two or more competing tender offers. Bloomenthal, *supra,* at 49; see 17 C.F.R. § 240.14d-7 (1981). Moreover, Bloomenthal has summarized the net effect of the SEC's recently revised tender offer regulatory program as providing the target company with a period of time in which to secure a better (higher) price for its shareholders. Bloomenthal, *supra,* at 71. It is submitted that it is somewhat anomalous to characterize the injury causing liability under rule 10b-5 in terms of the aims of the tender offer legislation, namely, higher prices for target company shareholders. *See also* Securities Exchange Act of 1934, § 14(d)(7), 15 U.S.C. § 78n(d)(7) (1976) (bidder is required to pay all shareholders the highest price offered during the course of tender offer regardless of when the shares were tendered).

62 *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476 (1977). The securities markets are inherently volatile, and susceptible to change based upon rumors, indications from large blocks of trading, and the announcement of corporate information. *See* Heller, *supra* note 57, at 526-32. Indeed, the success of the *Newman* scheme depended on the inevitable rise in the price of the target company stock as the market reacted to the public announcement of the tender offer. *See* 664 F.2d at 15. Liability for affecting securities prices, however, is extremely circumscribed by the requirement that the trader or disseminator of information must have had the specific motive to manipulate prices. Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 383 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973). The *Santa Fe* Court observed that “‘[m]anipulation’ is ‘virtually a term of art when used in connection with securities markets.’ The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.” *Santa Fe* Indus., Inc. v. Green, 430 U.S. at 476 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976)). The trading of the *Newman* defendants in breach of their fiduciary duties, albeit capable of affecting the price for target company shares, did not constitute manipulation as contemplated by rule 10b-5.

In *Santa Fe*, the Court considered whether certain breaches of fiduciary duties by corporate management constituted fraud within the meaning of rule 10b-5. *See* 430 U.S. at 471-76. In the course of determining that the activities in question did not rise to the level...
injury suffered by the tender offeror, however, appears to be premised upon the tenuous notion that the tender offeror possessed a right to purchase the target company stock in a natural securities market unsullied by leaks of secrets or breaches of confidentiality.\textsuperscript{63} It is submitted that this rationale amounts, in essence, to the "market insider" approach that was expressly rejected by the Supreme Court in Chiarella, an approach which was premised on the notion of a natural securities marketplace requiring equal access to information to remain "unsullied."\textsuperscript{64}

**CONCLUSION**

Foreclosed by Chiarella from imposing liability for nondisclosure to the sellers of the target company stock, the Second Circuit has pursued a new direction for rule 10b-5 which recognizes outsider liability based upon the theory of a "fraud on the source" of the information.\textsuperscript{65} Despite the arguable need for a theory of liability to address the type of misconduct left unchecked by Chiarella,\textsuperscript{66} it is submitted that the Newman court's approach is inconsis-
tent with recent signals from the Supreme Court that the scope of rule 10b-5 requires definition, not expansion. Thus, it appears that the novel theory of liability fabricated in *Newman* may, ultimately, fail to survive scrutiny by the Court.

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