81-1225

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

UNITED STATES OF AMERICA,

Appellant,

v.

E. JACQUES COURTOIS, *et al.*,

Defendants,

JAMES MITCHELL NEWMAN, a/k/a "Barnett,"

Defendant-Appellee.

On Appeal from the United States District Court
for the Southern District of New York

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION, *AMICUS CURIAE*

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Appellant,

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BRIEF FOR THE SECURITIES AND
EXCHANGE COMMISSION, *AMICUS CURIAE*

ISSUE PRESENTED

The Securities and Exchange Commission respectfully submits this brief, *amicus curiae*, addressed to the following question:

Whether the defendant had notice that, during the period from 1973 to 1978, his misappropriation of information from the corporate clients of investment bankers who were seeking advice concerning forthcoming acquisitions and his secret trading based on this information in the securities of the companies that were the targets of the proposed bids would constitute a violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION AND SUMMARY OF ITS POSITION

The Securities and Exchange Commission, the agency charged with the primary responsibility to enforce and administer the federal securities laws, including the Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq.*, submits this brief, *amicus curiae*, to address important issues raised in this appeal concerning the scope of Section 10(b) of the Securities Exchange Act, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5. While this appeal turns upon issues relating to the standards of the notice required before a defendant may be held answerable criminally for his misconduct, the holding of the court below calls directly into question the ability of the Commission to deal with trading abuses such as those alleged here under Rule 10b-5. The district court's decision turned largely upon its view that uncertainty existed in the application of that rule to these trading abuses. As such, that holding directly affects the responsibilities of the Commission to administer the federal securities laws.

This *amicus* brief will present the Commission's views with respect to the whether the defendants violated Rule 10b-5 by misappropriating and trading upon confidential, material information from companies involved in merger, acquisition, and takeover situations, the alleged violations that were dismissed by the district court. Because the Commission has no responsibility in administering the conspiracy statute, 18 U.S.C. §371, or the federal mail and wire fraud statutes, 18 U.S.C. §§1341, 1343, we will not address the issues concerning the alleged violations of these statutes.

The court below dismissed the indictment of James Mitchell Newman, based in part upon its belief that he lacked notice that his conduct vio-

lated Rule 10b-5 when he, in concert with two employees of investment bankers Morgan Stanley & Co., Inc. ("Morgan Stanley") and Kuhn Loeb & Co. ("Kuhn Loeb"), conspired to misappropriate highly sensitive, confidential information from various clients of those two firms relating to forthcoming takeover bids, and to profit therefrom by purchasing securities of the target companies prior to public announcement of the bids. The Commission submits that the district court was in error in holding that there was no "'clear and definite statement' in the federal securities laws which both antedated and proscribed" Mr. Newman's conduct (App. 356). 1/

Prior to the inception of the alleged illegal scheme, the Supreme Court had held that _any_ fraud involving the purchase or sale of a security violated Rule 10b-5. _Superintendant of Insurance_ v. _Bankers Life & Casualty Co._, 404 U.S. 6, 12 (1971). Other courts have also issued similar rulings. The "garden-variety" type of fraud involved here plainly fell within the ambit of Rule 10b-5. 2/ And significantly, the fact that the defendant -- an experienced securities trader -- and his co-conspirators -- two of whom were sophisticated investment bankers -- traded securities of target companies through secret foreign bank accounts, used aliases to hide their true identity, and made false statements to government and stock exchange personnel is a compelling indication that Mr. Newman knew that his conduct was unlawful.

Finally, we submit that the district court also erroneously decided that Mr. Newman was not properly indicted under Rule 10b-5 with respect to

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1/ "App. --" refers to pages of the paginated Appendix.

2/ Even the district court conceded, "[i]f the allegations of this indictment are true, Newman and the other defendants engaged in dishonorable and despicable conduct" (App. 371).

two instances where he traded in the securities of target companies without disclosing to his sellers, in violation of a pre-existing fiduciary duty to those sellers, non-public, inside information that had been misappropriated from the target companies.

While, as discussed below, the Commission has through recent adoption of a rule prohibited persons from taking unfair advantage of material non-public information relating to planned tender offers, the type of fraud alleged in this case is in important respects different from that prohibited by that rule. Moreover, the rule, having been promulgated under the tender offer provisions of the Securities Exchange Act, does not apply outside the tender offer area; thus, for example, mergers and negotiated acquisitions are not within its purview.

Accordingly, for the reasons discussed below, the Commission submits that the district court erred in dismissing the indictment of Mr. Newman under the federal securities laws and urges this Court to reverse that decision.

STATUTES AND RULES INVOLVED

Sections 10(b) and 14(e) of the Securities Exchange Act, 15 U.S.C. 78j(b), 78n(e), and Rules 10b-5 and Rule 14e-3 promulgated thereunder, 17 C.F.R. 240.10b-5, 240.14e-3, are set forth in the statutory appendix.

STATEMENT OF THE CASE

1. Proceedings in the District Court

An indictment was filed (81 Cr. 53) in the Southern District of New York charging defendant Newman, and three other co-defendants 3/ with vio-

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3/ E. Jacques Courtois, Jr., Franklin Carniol, and Constantine Spyropoulos.

lations of the conspiracy statute, 18 U.S.C. §371, and substantive violations of the mail and wire fraud statutes, 18 U.S.C. § 1341, 1343, and Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5. On April 16, 1981, defendant Newman moved to dismiss the indictment, and on May 20, 1981, the district court (Haight, J.), notwithstanding the fact that it found Mr. Newman's conduct "dishonorable and despicable" (App. 371), dismissed Mr. Newman's indictment with respect to all of the charged violations. On June 5, 1981, the district court filed its Memorandum Opinion explaining the basis for its dismissal of the indictment (App. 335-379). The indictment of co-defendants Courtois, Carniol and Spyropoulos were not similarly dismissed because these defendants had left the court's jurisdiction before being arraigned or otherwise appearing before the court (App. 379 n.44). The government is attempting to extradite these defendants for arraignment, all of whom are outside the United States (App. 373 n.1).

This is an appeal by the United States from the order dismissing the indictment.

2. The Nature of the Transactions in Issue 4/

This case involves the misappropriation, from investment bankers and their corporate clients, of information concerning corporate mergers and tender offers. It is appropriate at the outset, therefore, to briefly examine the nature of the subject transactions and the role of the invest-

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4/ As acknowledged in the lower court's opinion in this case (App. 373 n.3), "[f]or purposes of testing the legal sufficiency of the indictment, the facts recited are assumed to be true." See United States v. Black, 291 F.Supp. 262, 264 (S.D.N.Y. 1968). For purposes of this brief, the Commission has assumed the relevant allegations of the indictment to be true.

ment banker in this area.

In a merger, two companies join together to form a single entity, in a process that involves approval by the boards of directors (and usually the shareholders) of both companies. In a tender offer, one company makes an offer directly to the shareholders of another company to acquire their shares. The subject company's management may or may not approve of the bid. 5/

An investment banker is often retained by a corporation in an advisory capacity when a company contemplates a merger or tender offer. With respect to tender offers, the investment banker may represent either the company making the tender offer or the target company. When representing the tender offeror, the primary functions of the investment banker are to advise the client as to structure, strategy and tactics, to create confidence in the arbitrage community, to assist in the solicitation of shareholders and major institutional holders, and to provide an independent review of disclosure requirements under the federal securities laws. 6/ An investment banker representing a target company usually provides the client's board of directors an analysis of the fairness and adequacy of the offer, may assist the client in finding and negotiating with a "White Knight," *i.e.*, a more friendly firm interested in making a tender offer for the client, assists in negotiations with the tender offeror, and often assists in formulating defensive strategies and in communicating

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5/ See Fleischer & Mundheim, *Corporate Acquisition By Tender Offer*, 115 U. Pa. L. Rev. 317, 318 (1967).

6/ I M. Lipton and E. Steinberger, *Takeovers and Freezeouts*, ¶ 8.1 (1978).

with the stock exchanges and the investment community. 7/ In a merger situation, the nature of the advice is similar, but with greater emphasis on the negotiations between the two companies. Because of the sensitive (and often tentative) nature of the initial planning stages of an acquisition, the investment banker's involvement with its client is on a highly confidential basis. 8/

In order to deal with particular abuses in connection with corporate acquisitions by tender offers, Congress amended the Securities Exchange Act in 1968 by adding Sections 13(d) and (e) and 14(d) and (e), generally known as the Williams Act. 9/ Section 13(d) requires any person to disclose promptly to the public the fact that he has acquired more than 5% of a class of equity securities of another publicly-held company. Section 14(d) provides substantive regulatory provisions and disclosure requirements for the conduct of tender offers. And Section 14(e) prohibits "fraudulent, deceptive or manipulative" acts or practices in connection with a tender offer, and gives the Commission rulemaking authority to define and prescribe means reasonably designed to prevent such acts or practices. The Williams Act, speaking to tender offers, does not reach acquisitions through corporate mergers or combinations.

3. Facts

From the early 1970's to 1979, defendant E. Jacques Courtois was employed by Morgan Stanley, an investment banking firm (App. 4, Indict-

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7/ Id. at 404.

8/ See A. Fleischer, Tender Offers: Defenses, Responses and Planning 6 (1978).

9/ 15 U.S.C. 78m(d) - 78m(e), 78n(d) - 78n(f).

ment ¶ 2). In 1976, Courtois became a member of Morgan Stanley's Mergers and Acquisitions department, which represented companies engaged in corporate mergers, acquisitions, tender offers, and other takeover situations (App. 4, Indictment ¶ 2). On July 1, 1977, Mr. Courtois became a vice-president of Morgan Stanley, and remained in that position until leaving the firm in February 1979 (App. 4, Indictment ¶ 2).

From 1972 to 1975, unindicted co-conspirator Adrian Antoniu 10/ was also employed by Morgan Stanley, as an associate in the Corporate Finance department (App. 4, Indictment ¶ 3). In May 1975, Antoniu left Morgan Stanley to become an associate in the Mergers and Acquisitions department of Kuhn Loeb, another investment banking firm, 11/ and remained at Kuhn Loeb until July 1978 (App. 5, Indictment ¶ 3).

As members of the Mergers and Acquisitions departments of Morgan Stanley and Kuhn Loeb, Messrs. Courtois and Antoniu were constantly exposed, as a function of their employment, to confidential information entrusted by clients to Morgan Stanley or Kuhn Loeb concerning possible involvement in mergers, acquisitions, and tender offers (App. 8, Indictment ¶ 10). Notwithstanding their fiduciary duty to maintain the confidentiality of information acquired in their employment capacity, Messrs. Courtois and Antoniu -- both experienced investment bankers and well aware of the profits that could be made from trading securities on non-public information -- conspired during the period from 1973 to 1978 (App. 7, 10, 11, 12, 17,

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10/ On November 13, 1980, Mr. Antoniu pled guilty to a two-count information charging him with Rule 10b-5 violations and therefore was not named as a defendant in the indictment.

11/ Kuhn Loeb has merged with Lehman Brothers, and is presently known as Lehman Brothers Kuhn Loeb, Inc.

Indictment ¶ 7, 11, 12) to misappropriate confidential information concerning possible takeovers from corporate clients of Morgan Stanley and Kuhn Loeb (App. 9, 10, Indictment ¶ 10). They transmitted this information to defendant Newman and two other co-conspirators, 12/ who, largely through the use of secret foreign accounts, purchased the securities of the companies that were the planned targets of the takeover discussions (App. 10, Indictment ¶ 10). 13/

During that period, the defendants purchased the stock of eighteen target companies based on information misappropriated from Morgan Stanley and Kuhn Loeb clients (App. 6, Indictment ¶ 6). Sixteen of these clients were bidding companies and two clients were target companies whose securities were purchased by the defendants (App. 6. 7, Indictment ¶ 6). The defendants later sold the target company securities after the prices had risen in response to the announcement of the bids, and the profits were divided among the co-conspirators (App. 12, 13, Indictment ¶ 11).

In carrying out their plan, the defendants took elaborate steps to ensure that their scheme and identities would not be detected. They either made their purchases for cash or through foreign bank and trust accounts, where it was possible to secretly place orders without being identified on

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12/ Franklin Carniol and Coinstantine Spyropoulos.

13/ Initially, Mr. Antoniu, as an employee of Morgan Stanley, passed confidential information to Mr. Newman, who financed and traded the target company securities (App. 10, Indictment ¶ 11). In 1975, Mr. Courtois joined the conspiracy, and began to pass information to Mr. Antoniu, who, then an associate at Kuhn Loeb, communicated the information to Mr. Newman (App. 12, Indictment ¶ 11) who traded on it. Antoniu also enlisted the services of his friends Carniol and Spyropoulos, who traded securities of target companies through secret accounts in Europe (App. 11, Indictment ¶ 11).

brokerage or stock exchange records (App. 11, Indictment ¶ 11). 14/ The defendants avoided meetings with each other and Messrs. Newman, Carniol and Spyropoulos used aliases when they left telephone messages for Messrs. Courtois and Antoniu at Morgan Stanley and Kuhn Loeb (App. 13, Indictment ¶ 11). False and misleading statements were also made to governmental and stock exchange personnel who inquired about certain of the securities trading activities of the conspirators (App. 13, Indictment ¶ 11). Through their scheme, the defendants purchased tens of thousands of shares of stock of the target companies prior to the public announcement of the offers and profited accordingly.

4. The District Court's Decision

On May 20, 1981, the district court dismissed the indictment against Mr. Newman. With respect to the securities law counts, the district court held that his conduct in conspiring to misappropriate highly sensitive, confidential information from various clients of Morgan Stanley and Kuhn Loeb relating to impending acquisitions, and profiting therefrom by purchasing the securities of the target companies prior to announcement of the bids, did not state an indictable offense because "there was no 'clear and definite statement' in the federal securities laws which both antedated and proscribed" Mr. Newman's alleged misconduct. The court reasoned that there were no judicial opinions or Commission enforcement actions during the relevant period that would have put the defendant on notice that his misappropriation of information and subsequent trading was unlawful under

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14/ Mr. Newman traded through trust accounts in the Bahamas and Bermuda; Mr. Carniol traded through bank accounts in Luxembourg; and Mr. Spyropoulos traded through bank accounts in Switzerland (App. 11, Indictment ¶ 11).

the federal securities laws. The court also concluded that the Commission had contributed to the uncertainty in this area by rejecting the application of Rule 10b-5 to "warehousing," a practice the court described as analogous to the defendant's alleged misconduct. Finally, the court found significant to its conclusion of uncertainty the timing of the Commission's 1980 promulgation of its Rule 14e-3, 17 C.F.R. 240.14e-3, which proscribes under Section 14(e) of the Securities Exchange Act conduct of the type engaged in by the defendant. This appeal, on an expedited basis, followed.

DISCUSSION

I. THE DISTRICT COURT ERRED IN DISMISSING THE INDICTMENT ON THE GROUND THAT DEFENDANT NEWMAN COULD NOT HAVE BEEN ON NOTICE THAT HIS CONDUCT CONSTITUTED SECURITIES FRAUD

A. The Standard for Criminal Notice

As the defendants in this case are charged with criminal violations of the securities laws, such violations can only be found if the defendant, at the time of his misconduct, was sufficiently on notice that his actions amounted to securities fraud, see United States v. Harris, 347 U.S. 612 (1954). Yet, as previously recognized by this Court, the principal condition for sufficient notice is simply that "a clear and definite statement of the conduct proscribed" antedate the actions alleged to be criminal. United States v. Persky, 520 F.2d 283, 288 (2d Cir. 1975). Upon reviewing the language of Rule 10b-5, judicial opinions, and Commission enforcement efforts in this area, it becomes clear that Mr. Newman had sufficient notice that his "contemplated conduct [was] forbidden by * * * statute." United States v. Harris, supra, 347 U.S. at 617.

First, it is important to recognize that knowledge that one is violat-

ing the law is not necessary to sustain a criminal conviction. In Arthur Lipper Corp. v. Securities and Exchange Commission, 15/ a broker-dealer and its principal owner barred from the securities business by the Commission for violating Rule 10b-5 argued before this Court on appeal of the administrative decision that they did not violate Rule 10b-5 because they did not "realize that [their] conduct was fraudulent." In rejecting this argument, Judge Friendly stated that "it is no answer that petitioners may not have realized that [this] 'cunning device' was a fraud," and that "even in the criminal context neither knowledge of the law violated nor the intention to act in violation of the law is generally necessary for conviction." 16/

Thus, if a person may be convicted for committing a crime without knowing that he was violating the law, a fortiori the defendants in this case, because of their apparent knowlege of their wrongdoing, can properly be indicted and convicted for their criminal conduct. In this regard, it is difficult to believe that Messrs. Courtois and Antoniu, as sophisticated investment bankers, and Mr. Newman, as an experienced securities trader,

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15/ 547 F.2d 171 (2d Cir. 1976), reh. denied, 551 F.2d 915, cert. denied, 434 U.S. 1009 (1978).

16/ Judge Friendly quoted Justice Holmes in Ellis v. United States, 206 U.S. 246, 257 (1907), where "in rejecting a claim that knowledge of the law was required for a conviction under a statute that included the word "intentional," it was stated, "[i]f a man intentionally adopts certain conduct and that conduct is forbidden by law under those circumstances, he intentionally breaks the law in the only sense in which the law ever considers intent." Id. at 181 n.7.

This case does not involve a situation where a defendant proves he had no knowledge of the rule or regulation claimed to be violated and therefore cannot be imprisoned upon conviction. See Section 32(a) of the Securities Exchange Act, 15 U.S.C. 78ff. In any event, that provision does not prohibit conviction, only imprisonment.

did not know that profiting by trading on misappropriated, nonpublic information, to the possible detriment of the Morgan Stanley and Kuhn Loeb clients, was fraudulent. Indeed, the secrecy Mr. Newman and his co-conspirators employed is compelling evidence that they were well aware that they were violating the securities laws.

The *Lipper* decision also belies any argument that defendant Newman was not given sufficient notice of the illegality of his conduct by Commission initiated federal court complaints and consent decrees because these matters were unlitigated, and hence, had no precedential value. 17/ Irrespective of whether "civil consent decrees * * * can[ ] transform behavior denounced by the SEC into criminal conduct" (App. 353), the district court's standard for finding a criminal violation is inapposite in determining whether a defendant was on notice that his conduct might violate the law. Based on the reasoning of the lower court, a defendant would not be given sufficient notice, and hence, would not be subject to criminal prosecution, unless a person was previously convicted for conduct identical to that charged against a defendant. However, as the Court previously stated in *United*

17/ In *Lipper*, this Court suggested a more appropriate standard to determine whether a person is sufficiently on notice that certain conduct violates the law. There a broker-dealer argued that he could not be sanctioned for a willful violation of Rule 10b-5 because he relied on counsel's opinion that the proposed conduct was not unlawful although counsel acknowledged that this opinion "ran counter to a position as to the illegality * * * taken by the Commission's staff and indeed by the Commission * * *." While the court stated it would not attribute legal force to these Commission statements, 547 F.2d at 177, it nevertheless found them to be a "warning [to] the industry what position the Commission would be likely to take with respect to [the conduct]." *Id.* Thus, *Lipper* suggests that "willful" violations of the securities laws are supportable if a person is given sufficient notice by Commission statements that certain conduct may violate the law.

States v. Brown, 555 F.2d 336, 339-40 (2d Cir. 1977): "[t]he fact that there is no litigated fact pattern precisely in point may constitute a tribute to the cupidity and ingenuity of the malefactors, but hardly provides an escape from the penal sanctions of the securities fraud provisions here involved." 18/

Thus, consent decrees in Commission court actions, while having no precedential value in the sense of stare decisis, are quite relevant in determining whether the securities industry has been given notice that certain types of conduct might be unlawful. In this regard, prior to and during the period of defendants' misconduct (1973-1978), the Commission had brought numerous, well-publicized cases involving facts similar to those involved here in connection with corporate mergers, takeovers and tender offers. 19/

18/ Many criminal convictions have been sustained under the federal securities laws in situations where the legal issues were not entirely clear-cut, but where the defendant had full notice that his actions were indeed fraudulent. E.g., United States v. Brown, supra; United States v. Naftalin, 441 U.S. 768 (1979); U.S. v. Wolfson, 405 F.2d 779 (2d Cir. 1968), cert. denied, 394 U.S. 946 (1969). See also United States v. Charnay, 537 F.2d 341 (9th Cir. 1976).

19/ E.g., Securities and Exchange Commission v. Golconda, 1969-1970 CCH Fed. Sec. L. Rep. ¶ 92,504 (S.D.N.Y. 1969); Securities and Exchange Commission v. Bradford, 72 Civ. 4776 (S.D.N.Y. 1972) reported in Fridrich v. Bradford, 542 F.2d 307, 311-312 (6th Cir. 1976); Securities and Exchange Commission v. Shapiro, 349 F.Supp. 46 (S.D.N.Y. 1972), aff'd, 494 F.2d 1301 (2d Cir. 1974); Securities and Exchange Commission v. Healey, 5 SEC Docket 15 (S.D.N.Y. November 18, 1974); Securities and Exchange Commission v. Geon, 381 F.Supp. 1083 (S.D.N.Y. 1974), aff'd in part at 531 F.2d 39 (2d Cir. 1976); Securities and Exchange Commission v. Sorg Printing, 1974 CCH Fed. Sec. L. Rep. ¶ 94,767 (S.D.N.Y. 1974); Securities and Exchange Commission v. Rosenberg, 1976 CCH Fed. Sec. L. Rep. ¶ 94,766 (S.D.N.Y. 1974); Securities and Exchange Commission v. Ayoub, 1976 CCH Fed. Sec. L. Rep. ¶ 95,567 (S.D.N.Y. 1976); Securities and Exchange Commission v. Primar Typographers Inc.,

(footnote continued)

These actions served stark warning on those involved in such activity that their conduct was viewed by the government as illegal under the securities laws.

B. Section 10(b) and Rule 10b-5 Apply To Defendant's Conduct

1. The defendants' misappropriation of confidential information, accomplished by concealment and deception, constitutes a fraud

The principal ground offered by the court below for its conclusion that defendant Newman was not on notice of the illegality of his conduct was a legal one: that misappropriation of the sort involved here was not a fraud in connection with the purchase or sale of a security. The court thus erroneously rejected the primary legal theory on which the indictment

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19/ (footnote continued)

1976 CCH Fed. Sec. L. Rep. ¶ 95,734 (S.D.N.Y. 1976). Such actions have continued. Securities and Exchange Commission v. Petrou, 13 SEC Docket 4 (D.D.C. 1977); Securities and Exchange Commission v. Chiarella, 77 Civ. 2534 (GLG) (S.D.N.Y. 1977); Securities and Exchange Commission v. Manderano, 1978 CCH Fed. Sec. L. Rep. ¶ 96,357 (D.N.J. 1978).

See also Securities and Exchange Commission v. Lockwood 16 SEC Docket 12 (S.D.N.Y. July 5, 1979); Securities and Exchange Commission v. Wright, 17 SEC Docket 20 (D.D.C., July 30, 1979); Securities and Exchange Commission v. Hechler, 17 SEC Docket No. 16 (D.D.C., July 5, 1979); Securities and Exchange Commission v. Stone, 15 SEC Docket No. 14 (S.D.N.Y., September 11, 1978); Securities and Exchange Commission v. Fike, 18 SEC Docket 3 (S.D.N.Y., August 23, 1979); Securities and Exchange Commission v. Krutt, 18 SEC Docket 5 (S.D. Fla., September 6, 1979); Securities and Exchange Commission v. Kirby, 18 SEC Docket 11 (S.D.N.Y., October 23, 1979); Securities and Exchange Commission v. Lopata, 19 SEC Docket 6 No. 8985 (D.D.C., January 20, 1980); Securities and Exchange Commission v. Hall, 1979-1980 CCH Fed. Sec. L. Rep. ¶ 97,292 (D.D.C. 1980); Securities and Exchange Commission v. Aoki, 20 SEC Docket 11 (S.D.N.Y., July 23, 1980); Securities and Exchange Commission v. O'Connell, 1980 CCH Fed. Sec. L. Rep. ¶ 97,669 (S.D.N.Y. 1980); Securities and Exchange Commission v. Wyman, 22 SEC Docket No. 3 (S.D.N.Y. 1981).

was based.

The defendants' secret conversion of confidential information operated as a fraud upon Morgan Stanley and Kuhn Loeb, their clients, and their clients' shareholders. As the Supreme Court recognized in Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 10-11 & n. 7 (1971), "misappropriation is a 'garden variety' type of fraud." Here defendants not only used the confidential information to their personal financial advantage, they did so contrary to express instructions prohibiting such misuse of information. This concealment and deception was fraudulent. 20/

The lower court attempted to distinguish the misappropriation in this case from the fraud found in prior judicial decisions, where the misappropriation of securities or proceeds resulted "in the direct deprivation of a party to the transaction" (App. 355-56). But this suggestion, that securities or money has greater economic value than information, failed to recognize that the misappropriation of information concerning a tender offer can, as we discuss below, have a significant economic impact upon a company.

20/ The breach of fiduciary duty by Courtois and Antoniu to Morgan Stanley and Kuhn Loeb, and their clients, is imputable to Newman and the other co-conspirators who participated in the scheme that effectuated the breach of duty. The court below recognized this: "Clearly, if Courtois and Antoniu breached duties to their employers and their employer's clients which implicate § 10(b), Newman may be prosecuted as a co-conspirator under 18 U.S.C. § 371, and on the substantive counts, as an aider and abetter under 18 U.S.C. § 2" (App. 343).

See Oil & Gas Ventures v. King, 250 F.Supp. 744 (D.D.C. 1966); Jackson v. Smith, 254 U.S. 586, 589 (1921); Sexton v. Sword S.S. Line Inc., 118 F.2d 708, 711 (2d Cir. 1941); Bankers Life and Casualty Co. v. Kirtley, 338 F.2d 1006, 1013 (8th Cir. 1964). See also Irving Trust Co. v. Deutsch, 73 F.2d 121, 125 (2d Cir. 1934); Hunter v. Shell Oil Co., 198 F.2d 485, 489 (5th Cir. 1952).

Pre-announcement purchases of securities of target companies can raise the price of the target company's securities and greatly increase the cost of the forthcoming tender offer. Thus, the misappropriation of information in this case concerning the impending tender offers, contrary to the district court's conclusion, "damaged [the clients of Morgan Stanley and Kuhn Loeb] in their role as future investors in the target companies" (App. 356).

A fraud based upon the misappropriation of information was recognized by the trial court in the pre-trial order denying a motion to dismiss the indictment in United States v. Chiarella, 450 F. Supp. 95 (S.D.N.Y. 1978), conviction affirmed 588 F.2d 1358 (2d Cir. 1978), reversed on other grounds 445 U.S. 222 (1980). There the district court concluded:

> "[T]here is no question that Chiarella wrongfully took corporate information — unquestionably material and non-public — entrusted to him by offering corporations, and used it solely for personal profit, which information was 'intended to be available only for a corporate purpose and not for the benefit of anyone.' * * * Chiarella's purchases further operated as a fraud upon the acquiring corporations whose plans and information he took while he was setting them in type, because his purchases might possibly have raised the price of the target companies' stock, increasing the costs of legitimate market purchases by such acquiring corporations, and thus constituted 'a manipulative or deceptive device or contrivance' within the prohibition of § 10(b) and Rule 10b-5."

450 F. Supp. at 96.

This Court agreed that petitioner's conduct in Chiarella operated as a fraud on the tender offerors as well as the sellers of securities:

> "[T]he indictment fairly charges Chiarella violated Rule 10b-5 by converting offerors' confidential information to his own use. It not only alleged that appellant's activities 'operated as a fraud and deceit upon the sellers of the aforementioned securities,' it also charged a 'scheme to defraud' in general terms. Clearly, violation of an agent's duty to respect client confidences, Restatement (2d) Agency § 395, transgresses Rule 10b-5, where, as here,

> the converted information both concerned securities and was used to purchase and sell securities."

588 F.2d at 1368 n. 14. 21/

Thus, as we discuss below, even though the Supreme Court reversed Chiarella's conviction, this authority is persuasive that the court below erred in suggesting that defendant Newman's secret conversion and use of confidential information was merely a breach of duty. The defendant's conduct amounted to a breach of a duty to be sure, but it also involved "some element of deception" (Santa Fe Industries, Inc. v. Green, supra, 430 U.S. 462, 475 (1977)) -- a material failure to disclose. And as the Supreme Court has noted, concealment, nondisclosure or deception in conjunction with a breach of fiduciary duty gives rise to the fraud prohibited by Section 10(b) and Rule 10b-5. See id. at 474-476 & n.15.

While involving mail fraud rather than securities law issues, this Court's recent holding in United States v. Von Barta, 635 F.2d 999, 1003 (2d Cir. 1980), cert. denied, ___ U.S. ___, 49 U.S.L.W. 3710 (March 24, 1981), is also instructive. There it was held that breaches of fiduciary duty by an employee 22/ are transformed into criminal fraud when the employee conceals the abuse of his fiduciary position and has an obligation

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21/ As discussed below, the Supreme Court reversed Chiarella's conviction, 445 U.S. 222 (1980), but did not reach the merits of the misappropriation claim.

22/ In Von Barta, the defendant was charged with "abusing his fiduciary position as an employee . . . and concealing material information" thereby "defraud[ing] [the employer] of its right to his honest and faithful services, as well as its right to decide what business risks to bear with all the facts before it." Id. at 1003.

to disclose material facts with respect to such abuse. 23/ In this case, Messrs. Courtois and Antoniu had a duty, by the terms of their employment, to disclose to Morgan Stanley and Kuhn Loeb their interests in any securities transactions, and by their nondisclosure deceived their employers and their employers' clients. 24/

And as noted above, such deception poses a threat to the client bidding companies in cases of this type, far greater than the deprivation "of their agents' duty of loyalty and ethical behavior" considered by the court below (App. 356). Pre-announcement secrecy is essential to the success of tender offers. Morgan Stanley and Kuhn Loeb, recognizing the importance of such secrecy, require their employees to maintain the confidentiality of the information entrusted to them by corporate clients seeking advice concerning tender offers, and monitor their employees by requiring them to regularly report all trading of corporate securities (App. 9, Indictment ¶ 10).

Members of the securities industry familiar with the mechanics of tender offers have frequently emphasized the need for pre-announcement secrecy. For example, during hearings before Congress prior to the enactment of the Williams Act, Donald Calvin, Vice President of the New York Stock Exchange,

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23/ This Court stated "[t]he additional element which frequently transforms a fiduciary breach into a criminal offense is a violation of the employee's duty to disclose material information to his employer." Id. at 1006.

24/ Messrs. Courtois and Antoniu had an obligation to disclose their misappropriation to their employers, irrespective of any express employment agreement mandating such disclosure. As this Court stated in Von Barta, "[i]ndeed, the employment relationship, by itself, may oblige an employee not to conceal, and in fact to reveal, information he has reason to believe is material to the conduct of his employer's business." Id. at 1007.

testified that:

> "Obviously, a company intending to make a tender offer strives to keep its plan secret. If word of the impending offer becomes public, the price of the stock will rise toward the expected tender price. Thus, the primary inducement to stockholders -- an offer to purchase their shares at an attractive price above the market -- is lost, and the offeror may be forced to abandon its plans or to raise the offer to a still higher price. The cost of an offer to purchase hundreds of thousands of shares might prove prohibitive if the price had to be increased only a few dollars per share. * * * In spite of all precautions, there have been cases where tender offers have been preceded by leaks and rumors which caused abnormal market problems." 25/

In addition to the potential effect on price, leaks and unusual trading patterns may alert the target company to the bidder's plans, allowing it to commence communications with its shareholders to deflect the offer, prepare for litigation against the offeror, or attempt to find competing friendly bidders to defeat the offeror. 26/ Similarly, rumors, leaks and unusual trading patterns may alert the investment banking community and other potential tender offerors to the prospect of an attractive acquisition. This may trigger competing bids that result in expensive battles for control, and, in some situations, may result in total loss to the bidder of the target company. 27/

Thus, to avoid unfavorable price behavior, defensive maneuvers by the target company, and competing bids, the tender offeror relies upon his in-

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25/ Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids: Hearings on S. 510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess. 72 (1967). See also Hayes & Taussig, Tactics of Cash Takeover Bids, 45 Harv. Bus. Rev. 135, 139-140 (1967).

26/ Hayes & Taussig, supra n.25, at 142-47.

27/ See, e.g., Troubh, Purchased Affection: A Primer On Cash Tender Offers, 54 Harv. Bus. Rev. 79, 83 (chart) (1976).

vestment bankers to adhere to their fiduciary duty and maintain the tender offer plans in the strictest confidence. Messrs. Antoniu and Courtois, and their co-conspirators, engaged in the very kind of fraudulent behavior that could have frustrated the acquisition plans of the Morgan Stanley and Kuhn Loeb clients. The threat this posed more than suffices to establish fraud.

2. The defendants' fraud occurred "in connection with" the purchase or sale of securities and therefore violated Section 10(b) and Rule 10b-5

Because the defendants' scheme to defraud included -- indeed its purpose was -- their purchases of target company securities and also had a close relationship with (and potentially injurious effect upon) the securities purchases of the acquiring companies, their fraud clearly occurred "in connection with" purchase or sale transactions. 28/ Thus, the final requisite element of a violation of Rule 10b-5 is present.

Section 10(b) and Rule 10b-5 apply to "any" deceptive device or contrivance used in connection with a purchase or sale of securities. When a defendant employs deceptive practices "touching" the purchase or sale of securities, Section 10(b) and Rule 10b-5 are violated, regardless of the means used to achieve the fraud. Superintendent of Insurance v. Bankers Life & Casualty Co., supra, 404 U.S. at 12-13. As the Bankers Life case illustrates, concealed embezzlement or conversion, achieved through the

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28/ As noted above, the defendant's scheme would have been deemed fraudulent even under common law principles. The securities laws impose even greater standards of candor, as the Supreme Court has often recognized. See, e.g., Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194-195, 197-198, 201 (1963); Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972). See also III L. Loss, Securities Regulation 1430-1436 (2d ed. 1961).

vehicle of a securities transaction, constitutes a variety of fraud prohibited by Section 10(b) and Rule 10b-5.

There is no indication in the language of Section 10(b) or Rule 10b-5 that a fraud must be perpetrated directly upon a purchaser or seller to give rise to a violation of Rule 10b-5, and in the context of Commission injunctive actions and criminal actions involving both Rule 10b-5 and analogous provisions, the Supreme Court has held that there is no such requirement. Securities and Exchange Commission v. National Securities, Inc., 393 U.S. 453, 467 n. 9 (1969); United States v. Naftalin, 441 U.S. 768, 774 n.6 (1979). 29/ Thus, Mr. Newman and his co-conspirators violated Rule 10b-5 when they misappropriated information from, and hence defrauded, the clients of Morgan Stanley and Kuhn Loeb in connection with the defendants' purchases of target company securities.

The court below missed the point when it said that the defrauded

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29/ In Naftalin, the Supreme Court interpreted the scope of Section 17(a)(1) of the Securities Act of 1933 in the context of an alleged criminal violation of that provision. Section 17(a)(1) provides that "[i]t shall be unlawful for any person in the offer or sale of any securities * * * (1) to employ any device, scheme or artifice to defraud . . ." (emphasis supplied). The Supreme Court held that the language of Section 17(a)(1) does not require that the fraud occur in any particular phase of the selling transaction, and that, at least in a criminal prosecution, there is no requirement that a defrauded person under Section 17(a)(1) be a purchaser or seller. A fortiori, under Section 10(b) and Rule 10b-5, the "in connection" language would mandate protection at least equal to that provided under Section 17(a) of the Securities Act for persons who, though not purchasers or sellers, were defrauded in connection with a securities transaction.

See Securities and Exchange Commission v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963), where the Supreme Court stated "[a] fundamental purpose, common to [the securities] statutes, was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry."

clients of Morgan Stanley and Kuhn Loeb were not protected by Rule 10b-5 because those clients "were not damaged in their role as future investors in target companies" (App. 357). Defendants' fraud had a close relationship with the planned purchases of subject company securities by the acquiring company clients, potentially jeopardizing the takeovers by alerting competing bidders or hostile management determined to thwart the bids. 30/

Finally, as the Supreme Court reaffirmed in United States v. Naftalin, supra, 441 U.S. at 776, the fact that this part of the defendants' fraudulent scheme was directed toward a business, rather than an investor, provides no immunity from prosecution. The securities laws were intended to protect "honest business" as well as investors and thus to achieve "'a high standard of business ethics . . . in every facet of the securities industry'" (emphasis in original). Once again, all that is necessary is that the fraud touch on investment-related activity deserving the protection of the federal securities laws. 31/

30/ In Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), the Supreme Court held that a private plantiff may not recover damages under Rule 10b-5 unless he was a party to a securities transaction. However, in Blue Chip, the Court stated that this "purchaser-seller rule imposes no limitation on the standing of the SEC to bring actions for injunctive relief under §10(b) and Rule 10b-5." Id. at 751 n.14. The Supreme Court stated more recently in Naftalin that the Blue Chip rule does not apply in criminal actions for violations of Rule 10b-5. 441 U.S. at 774 n.6. Thus, it is clear that the Blue Chip rule does not interpret the "zone of interest" of Rule 10b-5, but merely limits the standing of certain individuals in private enforcement of the Rule seeking damages. See United States v. Persky, 520 F.2d 283, 288 n. 9 (2d. Cir. 1975).

31/ See United States v. Brown, 555 F.2d 336, 338 (2d Cir. 1977), where this Court found a violation of Section 17(a) of the Securities Act in a fraud on a transfer agent.

C. Chiarella v. United States, 445 U.S. 222 (1980), Does Not Support the District Court's Dismissal of the Indictment

The district court acknowledged that the Supreme Court's decision in Chiarella v. United States, supra, 445 U.S. 222, neither mandated nor guided the decision here (App. 342). Yet the distinction between this case and Chiarella is important in recognizing that the defendant had sufficient notice that his conduct violated Rule 10b-5. Chiarella arose from a series of stock transactions effected by Vincent Chiarella while he was employed in 1975 and 1976 by Pandick Press, a financial printer. Pandick prepared soliciting materials for bidders in upcoming tender offers. Though on notice that his conduct was prohibited by his employer, Chiarella would break secret codes inserted in the material being printed to hide the target's identity and then go into the market and purchase the target company's shares before the bid was announced. The announcement of the bid would thereafter lead to an increase in the price of the shares, approaching the premium being offered, and Chiarella would take his profit.

Chiarella was convicted of a criminal violation of Section 10(b) and Rule 10b-5 on two separate grounds: first, that he defrauded his purchasers or sellers by not disclosing the confidential information, and second, that he defrauded his employer's clients, the offerors, by misappropriating that information. His conviction was affirmed by this Court, which held that Chiarella, through his sensitive position as a financial printer, was a "market insider" -- a person whose position gave him regular access to market information. 588 F.2d at 1366-67. Accordingly, his trading on the basis of material non-public information obtained in that capacity without disclosure to those who were selling in the market was held illegal. In addition, this Court recognized that the fact that the information had been

misappropriated was itself a separate basis for finding his actions to be fraudulent — the very circumstance at issue in the present case. Id. at 1328 n.14.

The Supreme Court reversed Chiarella's conviction. The opinion for the court, written by Mr. Justice Powell, begins by reviewing the language and legislative history of section 10(b). Justice Powell noted that neithere the statute nor Rule 10b-5 directly addressed the issue of silence as a basis for liability for defrauding a purchaser or seller; instead, the Commission's Cady, Roberts decision in 1961 32/ had broken new ground by finding that corporate insiders breached a duty to the public by taking unfair advantage of their insider status through open market trading. 445 U.S. at 226. Nevertheless, the Commission's holding, according to the Court, was fully consistent with the common law of misrepresentation, where "the duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or similar relation of trust and confidence between them'". Id. at 228.

Under these standards, however, Chiarella was not an insider, for he had received no confidential "inside" information from the company whose shares he bought. The Court therefore held that Chiarella was under no duty of disclosure to his open-market sellers because he did not have a confidential or fiduciary relationship with the sellers:

> "No 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.

32/ In re Cady, Roberts & Co., 40 S.E.C. 907 (1961).

In Part IV of the opinion, the Court turned to the alternative ground for conviction that had been approved by this Court and the district court in the Chiarella case -- that Chiarella had fraudulently breached a duty to the acquiring company, and that this was sufficiently "in connection with" the purchase or sale of a security to base liability under Section 10(b). The Court noted that "the breach of this duty is said to support a conviction under § 10(b) for fraud perpetrated on both the acquiring corporation and the sellers." Id. at 235-36. The Court held, however, that this theory had not been properly charged to the jury. Consequently, the Court would "not speculate upon whether such a duty exists, whether it has been breached, or whether such a breach constitutes a violation of Section 10(b)." Id. at 237.

Justice Stevens joined in the Court's opinion and Justice Brennan, concurred in the holding. Writing separately, both made clear that they would have viewed the case much differently had the jury charge been more explicit on the misappropriation issue. Justice Stevens' opinion is especially noteworthy in that it emphasized the question the Court left open in Part IV, and now at issue in this case: whether Chiarella's breach of his duty of silence — "a duty he unquestionably owed to his employer and his employer's customers" would give rise to criminal liability under Rule 10b-5. Id. at 238. 33/

33/ Chief Justice Burger would have imposed liability under Rule 10b-5 for Chiarella's failure to disclose misappropriated material non-public information to the marketplace sellers of the subject company securities. Id. at 242-48. Justice Brennan agreed with this as a matter of law, but believed that the jury had not been properly charged on this point. Id. at 240. Justices Blackmun and Marshall would have imposed liability for failure to disclose information obtained by virtue of a position of special access to material information, whether or not derived from the issuer. Id. at 255-56.

The indictment of defendant Newman rests, of course, on the second ground upon which Chiarella was convicted, which was explicitly affirmed by this Court, and which was not reached by the Supreme Court -- what is here the fraud on Morgan Stanley, Kuhn Loeb, and their clients and the clients' shareholders, arising from the misappropriation of the confidential information. In dismissing the indictment for want of adequate notice the court below acted contrary to the holding of this Court in Chiarella, insulating from criminal liability conduct that was a fraud and a deceit within the meaning of Rule 10b-5 at that time.

D. The Indictment Also Charges Defendants With Violating Rule 10b-5 On a Well-Established "Insider" Trading Theory

The court below acknowledged that in two instances set forth in the indictment -- the bids for shares of Pan Ocean Oil Inc. and Robintech Co. -- Morgan Stanley or Kuhn Loeb represented not the bidding companies, but the subjects of the planned tender offers (App. 358). In these instances, quite apart from liability for fraudulent misappropriation under Rule 10b-5, the elements of classic insider trading liability -- long recognized by this and other courts, including the Supreme Court in Chiarella -- are also present. The investment banking firms -- and Messrs. Antoniu and Courtois as their employees -- were fiduciaries of their clients, owing them a duty, among other things, not to profit personally from confidential information received in the course of the fiduciary relationship. 34/ This relationship of trust and confidence, in turn, created a duty to disclose prior to any trading in the client's securities -- a duty owed in this case to the shareholders of the client companies who were about to

34/ See Restatement (Second) of Agency § 395 (1958).

sell their shares without the benefit of the information about the forthcoming takeover bids. In other words, defendants, as "insiders" of Pan Ocean and Robintech, defrauded the Pan Ocean and Robintech shareholders from whom they bought their shares.

Though acknowledging this, the court below believed that the indictment charged only a fraud on the client companies themselves. Because only shareholders of the target companies sold securities to the defendants, the court reasoned, the insider trading theory -- which requires a showing of a fraud on purchasers or sellers of securities -- had not been properly alleged in the indictment (App. 357).

This is an unduly narrow reading of the indictment. The indictment charges "a fraud and deceit on Morgan Stanley, Kuhn Loeb and those corporations and shareholders on whose behalf Morgan Stanley or Kuhn Loeb was acting and to whom Morgan Stanley or Kuhn Loeb owed fiduciary duties." 35/ Thus, the class of persons allegedly defrauded -- those to whom the fiduciary duty of full disclosure was owed -- included the Pan Ocean and Robintech shareholders who sold shares in the open market unaware of the impending bids.

Seen in this light, there is no question as to the validity of the charges in those instances where defendants purchased securities of Morgan Stanley or Kuhn Loeb's clients in anticipation of a takeover bid for those clients. Insider trading liability has long been imposed in cases involving information relating to corporate mergers and takeovers. 36/ The cate-

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35/ App. 8, 20; Indictment, ¶¶ 9, 15 (emphasis supplied).

36/ E.g., Securities and Exchange Commission v. Shapiro 494 F.2d 1301 (2d Cir. 1974); Sunstrand Corp. v. Sun Chemical Corp., 553 F.2d

(footnote continued)

gory of "insiders" to which this rule applies is not limited to corporate officers and directors; it extends to persons, like investment bankers, who serve the issuer in a confidential, fiduciary capacity, and thus have access to important information relating to the price of the issuer's securities. 37/ In Chiarella, the Supreme Court carefully reaffirmed the applicability of Rule 10b-5 to instances of nondisclosure of material non-public information by persons standing in such a fiduciary capacity vis-a-vis their purchasers or sellers. 38/

II. THE COMMISSION'S REGULATORY EFFORTS WITH RESPECT TO THE DUTY TO DISCLOSE TENDER OFFER-RELATED "MARKET INFORMATION" RELIED ON BY THE DISTRICT COURT IN DISMISSING THE INDICTMENT ARE UNRELATED TO THE ISSUES OF LIABILITY POSED IN THIS CASE

The court below pointed to two additional factors that led it to conclude that no "clear and definite statement" of liability for the type of conduct alleged existed at the time of defendants' conduct (App. 356).

36/ (footnote continued)

1033 (7th Cir.) cert. denied, 434 U.S. 875 (1977); Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969), cert. denied, 400 U.S. 822 (1970).

37/ See Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, 495 F.2d 228 (2d Cir. 1974). See also In re Cady, Roberts, 40 S.E.C. 907 (1961); In re Investors Management Corp., 44 S.E.C. 633 (1974).

In Chiarella, the Court noted that "tippees" of insiders may be charged with participation in the insider's breach resulting in trading on the basis of non-public information. 445 U.S. at n.14.

38/ 445 U.S. at 228. This Court has recognized the validity of the insider trading prohibition subsequent to Chiarella where such a fiduciary relationship exists. See Elkind v. Liggett & Myers Inc., 635 F.2d 156 (2d Cir. 1980).

First, Commission statements regarding the problem of "warehousing" and the applicability of Rule 10b-5 to that activity. Second, the Commission's rule-making efforts leading to the recent adoption of Rule 14e-3. Both factors, the court believed, evidenced uncertainty as to whether Rule 10b-5 applied to the activities charged in the indictment.

The court's concern is not well founded. The charges in this case, as discussed above, involve the misappropriation of information from the clients of Morgan Stanley and Kuhn Loeb. This is an issue not addressed by the Commission's actions noted above. 39/ Consequently, neither of these matters could create any uncertainty as to the applicability of Rule 10b-5 in reaching the very different types of fraud alleged in the indictment here. 40/

A. Questions Associated With "Warehousing" Are Not Relevant Here

When it enacted the Williams Act in 1968, Congress recognized that tender offers can perform a valuable economic function, to the benefit of company shareholders, notwithstanding their potential for abuse. Therefore, the Act tries to create a delicate balance between the interests of the bidder and the target company, so that shareholders' best interests are protected without discouraging bidders from making offers in the first place. 41/ One place where a careful balance was drawn is found in Sec-

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39/ Nor could those actions have any bearing on the instances where defendants bought and sold securities issued by the target clients of their employers.

40/ See Brodsky, Trading on Inside Information, New York Law Journal (June 17, 1981), p. 1.

41/ See S. Rep. No. 550, 90th Cong., 1st Sess. 3 (1967); Rondeau v. Mosinee Paper Corp., 422 U.S. 49, 58-59 (1975).

tion 13(d), which implicitly allows a bidder to acquire up to 5% of the target company's stock before making public disclosure of its intentions. Such preliminary acquisitions increase the chance that the later planned bid will be successful. While shareholders of the target company who sell in the open market immediately before the bid is announced are disadvantaged insofar as they can advantage of the later-offered premium, Congress determined that compelling premature disclosure would not, on balance, be in the public interest. 42/

"Warehousing" is the process by which bidders arrange with other parties to acquire target company shares on the open market prior to the announcement of the bid. Having the shares in friendly hands, of course, facilitates the subsequent bid. In its 1971 Institutional Investor Study, the Commission raised some question about the desirability of using Rule 10b-5 to deal with this issue, stating that its recommendations did

> "not necessarily mean that such passing on of information concerning takeovers should be permitted, but it may well mean that if such activities are to be prohibited, this should be done by a rule specifically directed to that situation rather than by an expanded interpretation of Rule 10b-5 resting on a somewhat different theory than that underlying that rule as to the obligations and duties of those who receive material undisclosed [corporate] information." 8 SEC Institutional Investor Study Report H.R. Doc. No 92-64 92d Cong. 1st Sess. xxii, xxxii.

This statement is merely reflective of the Commission's view that warehousing is a problem intimately related to how tender offers are conducted, for it represents but one of the means by which the bidder seeks to assure

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42/ See General Time Corp. v. Talley Industries Inc., 403 F.2d 159, 164-65 (2d Cir. 1968).

the success of its impending offer. 43/

It would be ironic, to say the least, if such a pronouncement with respect to the public disclosure obligations of persons acting at the direction or encouragement of the offeror company could insulate from liability persons, such as defendants here, who steal information from such companies and use it in defiance of the express instructions of their employers. The fraud that arises from such a misappropriation is a private deceit, involving none of the public disclosure issues that arise when the trader is acting in concert with the bidding company. No "person of ordinary intelligence" (App. 343) could have drawn from the Commission's statements a conclusion that the law somehow permits him to defraud a bidder by converting highly sensitive information for his personal profit. So, too, the warehousing issues are wholly inapposite to the situation where the trader is associated with the target company, rather than the bidder, and bears a fiduciary relationship to the target company's shareholders.

B. The Promulgation of Rule 14e-3 by the Commission Did Not Evidence a Determination that the Misconduct Here Was Not Prohibited by Rule 10b-5.

As anticipated in the Institutional Investor Study, the Commission began in the early 1970's to consider whether rulemaking would be appropriate to deal with the "outsider trading" problem in the tender offer context. Comments were requested in 1973 on the question of the duty to disclose to the investing public "knowledge about the existing or future mar-

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43/ The Supreme Court in Chiarella cited this language in support of its conclusion that no general duty of disclosure is owed to marketplace purchasers and sellers by outsiders possessing tender offer related information. 445 U.S. at 234. Once again, that theory of liability is not at issue here.

ket in particular securities," a question closely related to the tender offer problem. 44/ Then, in 1979, the Commission issued for comment proposed Rule 14e-2, which would have required a bidder that had "determined" to make a tender offer, and any person who learned, directly or indirectly from the bidder, of that determination, to disclose publicly that information prior to trading in the subject company's stock. 45/ A new proposal was published for comment in December 1979, 46/ and this was adopted by the Commission as Rule 14e-3 in September 1980. 47/ Rule 14e-3, which was adopted by the Commission pursuant to its authority under Sections 14(e) and 23(a) of the Securities Exchange Act, broadly prohibits persons other than the bidder from trading on material nonpublic information regarding a planned tender offer where that information has been acquired from the bidder or a person associated with the bidder. 48/

44/ Sec. Ex. Act Rel. No. 10316 (Aug. 1, 1973). Similar issues were raised with respect to other outsider trading situations where circumstances indicated the possibility of unfair informational advantage. E.g., Sec. Ex. Act Rel. No. 9950 (January 16, 1973); Sec. Ex. Act. Rel. No. 5526 (Sept. 9, 1974).

45/ Sec. Ex. Act. Rel. No. 15548 (February 5, 1979), 44 F.R. 9956.

46/ Sec. Ex. Act. Rel. No. 16385 (December 6, 1979), 44 F.R. 70349.

47/ Sec. Ex. Act. Rel. No. 17120 (September 12, 1980), 45 F.R. 60410.

48/ 17 C.F.R. § 240.14e-3 (1980):

"(a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of Section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from (1) the offering person, (2) the

(footnote continued)

The court below concluded that adoption of this Rule evidenced the Commission's belief that Rule 10b-5 was not available to reach trading on the basis of material non-public tender offer information: "[t]he inquiry posed presupposes a vacuum in the securities regulations then existing; surely, had the SEC perceived Rule 10b-5 as providing the answer [to the question of whether Rule 10b-5 applied to such "market information" cases], it need not have asked the question" (App. 351).

At the outset, rulemaking efforts like that leading to the adoption of Rule 14e-3 are not indications that a "vacuum" exists under more general authority. Were such a conclusion the law, the administrative process would be seriously restrained. While of course agencies engage in rulemaking to create new duties and obligations and these "fill vacuums," rules are promulgated also to revise or clarify existing law and provide more definite guidelines as between permitted and impermissible conduct in order to meet changing conditions. To take all rulemaking as a statement that all activity prohibited by the rule was theretofore permissible would

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48/ (footnote continued)

> issuer of the securities sought or to be sought by such tender offer, or (3) any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities 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."

In the Commission's view, the authority to compel disclosure of tender offer related information is present under Section 14(e) even in the absence of a pre-existing fiduciary duty. See 45 F.R. at 60412.

certainly deter agencies from ever seeking to clarify existing prohibitions. 49/

The more basic flaw in the reasoning of the court below, however, is its failure to recognize that -- as with the "warehousing" problem -- the Commission's efforts described above addressed a somewhat different problem from that involved in this case. Rule 14e-3 focuses on the circumstances under which a person must refrain from trading unless other open-market purchasers or sellers are aware of all material tender offer related information derived from the bidder. It thus imposes an abstain or disclose obligation under circumstances where no pre-existing fiduciary duty exists between the person possessing the information and those purchasers or sellers. It looks to the question of when full disclosure is necessary to prevent an unfair inequality of information among investors. 50/ It is not directed to the question of whether a person can defraud his employing investment banker or the client bidding company by misappropriating confidential information, or whether there is a fraud when the trader fails to disclose information obtained by virtue of a confidential relationship where the trader does in fact owe a duty as a fiduciary to those with whom he is trading. In light of the well-established bases for Rule 10b-5 liability under the circumstances of this case, the Commission's efforts with respect to the

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49/ Securities and Exchange Commission v. Chenery Corp., 332 U.S. 194, 201-03 (1947); National Labor Relations Board v. Bell Aerospace Corp., 416 U.S. 267, 290-95 (1974). The fact that some definition may be needed in certain unrelated areas of regulation does not, of course, render the law impermissibly vague under circumstances when the complainant's conduct is plainly covered. See United States v. Persky, 520 F.2d 283, 288 (2d Cir. 1975).

50/ See 45 F.R. at 60413.

duty to disclose problem addressed by Rule 14e-3 cast no shadow on the validity of the present indictment.

Moreover, the Commission indicated in the release adopting Rule 14e-3 that it continues to believe, quite apart from the Chiarella decision and the adoption of that rule, that "persons who unlawfully obtain or misappropriate material nonpublic information violate Rule 10b-5 when they trade on such information." 51/ This of course, builds upon the Commission's record throughout the 1970's in bringing Rule 10b-5 cases against persons trading on the basis of pre-announcement knowledge of an impending tender offer -- a record that belies the conclusion that the Commission believed that no such authority existed at the time. 52/ Since the adoption of the

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51/ Sec. Ex. Act Rel. No. 34-17102 (Sept. 12, 1980), 45 F.R. 60410, 60412. The release first proposing the rule also made clear that Rule 10b-5 remains applicable. Sec. Ex. Act Rel. No. 15548 (Feb. 5, 1979). The Commission believes that persons so misappropriating information from the bidder not only defraud the bidder, but marketplace purchasers and sellers as well. This latter theory was articulated by Chief Justice Burger, dissenting in Chiarella (445 U.S. at 240), and expressly not reached by the majority on the ground that the jury had not been properly charged on that theory. The duty to disclose under this theory arises not from any pre-existing duty, but is imposed by law as a result of the misappropriation or other unlawful use. See Keeton, Fraud -- Concealment and Nondisclosure, 15 Tex. L. Rev. 1, 25-26 (1936). This theory is not charged in the present indictment.

52/ The Commission has instituted numerous civil actions alleging violations of Rule 10b-5 by persons trading in target company securities while in possession of material, nonpublic information prior to the public announcement of a tender offer. See Securities and Exchange Commission v. Hall, No. 80-0504, filed Feb. 22, 1980 (D.D.C.), Lit. Rel. No. 9013 (special counsel to issuers making tender offers for their own stock purchased stock before the tender offers were announced); Securities and Exchange Commission v. Lopata, No. 80-0274, filed Jan. 29, 1980 (D.D.C.), Lit. Rel. No. 8985 (chairman of the board of directors of subject company tipped brother who purchased subject company stock before

(footnote continued)

rule last year, the Commission has in fact brought one case charging a violation of Rule 10b-5 where two persons misappropriated sensitive tender offer information from the bidder and traded thereupon. 53/

In sum, nothing in the Commission's regulatory or enforcement efforts with respect to the difficult issue posed in the Chiarella case -- the duty to disclose to one's marketplace purchasers or sellers material non-public "market" information derived from a bidding company, not the issuer — diminishes the clarity with which Rule 10b-5 proscribes conduct such as that alleged here. 54/ We believe that the court below erred in holding

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52/ (footnote continued)

the tender offer was announced); Securities and Exchange Commission v. Fike, No. 79 Civ. 4434, filed Aug. 23, 1979 (S.D.N.Y.), Lit. Rel. No. 8851 (secretary for director of subject company purchased subject company stock before the tender offer was announced); Securities and Exchange Commission v. Wright, No. 79-1981 filed July 30, 1979 (D.D.C.), Lit. Re. No. 8829 (director of subject company purchased subject company stock before an announcement that management supported tender offer by third party was made); Securities and Exchange Commission v. Hechler, No. 79-1729, filed July 5, 1979 (D.D.C.), Lit. Rel. No. 8811 (consultant to bidder and his brother-in-law purchased subject company securities before the tender offers were announced); Securities and Exchange Commission v. Stone, No. 78 Civ. 4259, filed Sept. 11, 1978 (S.D.N.Y.), Lit. Rel. no. 8527 (employee of bidder who was inadvertant tippee — "eavesdropper" — purchased target company stock before the tender offer was announced).

53/ Securities and Exchange Commission v. Wyman, Lit. Rel. No. 9311 (March 4, 1981), 22 SEC Docket 391.

54/ The fact that Section 14(e) and Section 10(b) might overlap in certain respects does not suggest that the former displaces the latter. See Securities and Exchange Commission v. National Securities Inc., supra, 393 U.S. at 468; United States v. Naftalin, 491 U.S. 768, 778 (1979). Indeed Judge Friendly has pointed out that Section 14(e) can be read in some respects as a codification of Rule 10b-5, designed, among other things, to avoid the purchaser-seller standing rule. See Electronic Speciality Co. v. International Controls Corp., 409 F.2d 937, 940-941 (2d Cir. 1969).

(footnote continued)

that these Commission actions suggested to a "person of ordinary intelligence" that the types of fraud alleged in this case were not proscribed by Rule 10b-5 at the time of the conduct.

CONCLUSION

For the foregoing reasons, we respectfully urge that the judgment of the district court dismissing the indictment was erroneous and should be reversed.

Respectfully submitted,

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54/ (footnote continued)

Numerous cases have recognized that fraud in connection with a tender offer may be reached under Rule 10b-5 as well. See, e.g., Schlick v. Penn Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974) cert. denied, 421 U.S. 976 (1975); Smallwood v. Pearl Brewing Corp., 489 F.2d 579 (5th Cir.), cert. denied, 419 U.S. 873 (1974).

STATUTORY APPENDIX

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b):

Sec. 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Commission Rule 10b-5, 17 CFR 240.10b-5:

Reg. § 240.10b-5. **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.

Section 14(e) of the Securities Exchange Act of 1934, 15 U.S.C. 78n(e):

Sec. 14. (e) It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

Commission Rule 14e-3(a)-(c), 17 CFR 240.14e-3(a)-(c):

Reg. § 240.14e-3. (a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from (1) the offering person, (2) the issuer of the securities sought or to be sought by such tender offer, or (3) any officer, director, partner or employee or any 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.

(b) A person other than a natural person shall not violate paragraph (a) of this section if such persons shows that:

(1) The individual(s) making the investment decision on behalf of such person to purchase or sell any security described in paragraph (a) or to cause any such security to be purchased or sold by or on behalf of others did not know the material, nonpublic information; and

(2) Such person had implemented one or a combination of policies and procedures, reasonable under the circumstances, taking into consideration the nature of the person's business, to ensure that individual(s) making investment decision(s) would not violate paragraph (a), which policies and procedures may include, but are not limited to, (i) those which restrict any purchase, sale and causing any purchase and sale of any such security or (ii) those which prevent such individual(s) from knowing such information.

(c) Notwithstanding anything in paragraph (a) to the contrary, the following transactions shall not be violations of paragraph (a) of this section:

(1) Purchase(s) of any security described in paragraph (a) by a broker or by another agent on behalf of an offering person; or

(2) Sale(s) by any person of any security described in paragraph (a) to the offering person.