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Securities - Misappropriation Theory - Extension of Liability Found in Rule 10b-5 - Carpenter v. United States

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CASENOTES

SECURITIES—Misappropriation Theory - Extension of Liability Found in Rule 10b-5. *Carpenter v. United States*, 108 S. Ct. 316 (1987).

Foster Winans, coauthor and reporter for the *Wall Street Journal's* (*WSJ*) "Heard on the Street" ("Heard") daily column, reviewed negative and positive aspects of various stocks for *WSJ* readers.¹ Winans regularly interviewed corporate executives to obtain the columns' information. In the interviews, Winans did not receive any corporate inside information or "hold for release" information, nor did the column contain any such information.² The *WSJ's* policy treats all information gathered by employees during the course of employment as confidential company property.³

Winans entered into a scheme with Peter Brant and Kenneth Felis, both of the Kidder Peabody brokerage firm, in which Winans gave them advance information of the contents and timing of the "Heard" column.⁴ David Carpenter participated in the scheme by serving as a messenger between the defendants.⁵

Due to the perceived quality and integrity of the "Heard" column, the column had the potential to affect the price of the stocks the column examined.⁶ Over four months the brokers made prepublication trades on the *WSJ's* confidential information contained in approximately twenty-seven columns.⁷ The scheme resulted in net profits of \$690,000 for the defendants.⁸

The district court⁹ relied on the misappropriation theory to find that the defendants violated the securities laws. The court found the defendants guilty of engaging in a scheme which operated as fraud and deceit on the *WSJ* and the Dow Jones & Co., Inc.¹⁰

The United States Supreme Court, by an evenly divided court,¹¹ affirmed convictions for violation of section 10(b) of the Securities

1. *Carpenter v. United States*, 108 S. Ct. 316, 319 (1987).

2. *Id.*

3. *Id.*

4. *Id.*

5. *United States v. Carpenter*, 791 F.2d 1024, 1026 (2nd Cir. 1986).

6. *Carpenter*, 108 S. Ct. at 319.

7. *Id.*

8. *Id.*

9. *United States v. Winans*, 612 F. Supp 827 (S.D.N.Y. 1985) refers to the district court decision. When the case was appealed to the Second Circuit Court of Appeals, the case name was changed to *United States v. Carpenter*. The case name in the Supreme Court was *Carpenter v. United States*.

10. *Winans*, 612 F. Supp. at 849.

11. Affirmance of a decision by an equally divided court affirms the lower court's judgment or decree, and has no precedential effect. 12 J. MOORE, H. BENDIX, B. RINGLE, *MOORE'S FEDERAL PRACTICE* ¶ 400.05-3 (2d ed. 1988).

Exchange Act of 1934, 15 U.S.C. section 78j (b),¹² and Rule 10b-5, 17 C.F.R. section 240.10b-5.¹³ The Court, by a unanimous decision, affirmed the convictions under the federal wire and mail statutes, 18 U.S.C. sections 1341,¹⁴ 1343.¹⁵

Traditionally, the courts have construed the securities laws narrowly, but some courts have seen a trend towards broadening the basis of liability. This casenote examines the appropriate liability under the securities laws for the misappropriation of material nonpublic information used in securities transactions.

12. *Carpenter*, 108 S. Ct. at 320. Section 10(b) 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 -

....

(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.

Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (1982).

13. *Carpenter*, 108 S. Ct. at 320. 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 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.

Rule 10b-5, 17 C.F.R. § 240.10b-5 (1987).

14. *Carpenter*, 108 S. Ct. at 320. Section 1341 provides:

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

18 U.S.C. § 1341 (1982).

15. *Carpenter*, 108 S. Ct. at 320. Section 1343 provides:

Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, transmits or causes to be transmitted by means of wire, radio, or television communication in interstate or foreign commerce, any writings, signs, signals, pictures, or sounds for the purpose of executing such scheme or artifice, shall be fined not more than \$1,000 or imprisoned not more than five years, or both.

18 U.S.C. § 1343 (1982).

BACKGROUND

Neither the Securities and Exchange Commission rules nor the statutes define the practice of "insider trading." In general, "insider trading" refers to unlawful trading in securities of a company about which the trader possesses material nonpublic information.¹⁶

The courts have developed several theories of liability based upon trading on material nonpublic information.¹⁷ In *Chiarella v. United States*,¹⁸ the Supreme Court established the duty to disclose or abstain rule. A person violates Rule 10b-5 under the disclosure or abstain theory by trading on material nonpublic information in which the person has an affirmative duty to disclose the information before trading.¹⁹

The common law recognized that corporate insiders, particularly officers, directors, or controlling stockholders, have an affirmative duty to disclose to the securities market nonpublic information they use when transacting in their corporation's securities.²⁰ The Supreme Court incorporated these common law elements in establishing a Rule 10b-5 violation. A court must find "(i) the existence of a relationship affording access to inside information intended to be available for corporate purpose, and (ii) the unfairness of allowing a corporate insider⁽²¹⁾ to take advantage of that information by trading without disclosure."²²

The misappropriation theory is another theory of securities laws liability which at least the Second Circuit recognizes.²³ Fraud in this theory is perpetrated on the person who entrusted the information to the other party²⁴ rather than fraud in the failure to disclose.²⁵ With the misappropriation theory, the fraud occurs when a person misuses material nonpublic

16. D. LANGEVOORT, SECURITIES LAW SERIES, INSIDER TRADING HANDBOOK, § 1.01 (1987).

17. The duty to disclose or abstain from trading theory and the misappropriation theory are addressed by the casenote. The adoption of 17 C.F.R. § 240.14e-3 (1985) created another theory for liability. The Securities and Exchange Commission adopted Rule 14e-3 to attack improper trading in connection with tender offers. Tender offers are unique transactions; therefore, they are not addressed by this casenote. See D. LANGEVOORT, *supra* note 16, § 7.

18. 445 U.S. 222 (1980).

19. *Id.* at 228. The duty to disclose occurs when a person has information that the other party is entitled to because a fiduciary relationship of trust and confidence exists between them. *Id.* (citing RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)).

20. *In re Cady, Roberts, & Co.*, 40 S.E.C. 907, 911 (1961).

21. A corporate insider is a director or officer who has knowledge of material nonpublic information due to a corporate position. These insiders have a duty to refrain from using this privileged information for personal benefits. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2nd Cir. 1968).

22. *Chiarella*, 445 U.S. at 227 (citing *In re Cady*, 40 S.E.C. at 912 n. 15).

23. *United States v. Newman*, 664 F.2d 12, 19 (1981).

24. In *Carpenter*, the fraud was on the *WSJ* and the Dow Jones Co., Inc. when Winans released the confidential information. The securities transacted by the defendants were not related to the *WSJ* or the Dow Jones Co., Inc. *Carpenter*, 791 F.2d at 1032.

25. Traditionally, when a person trades on information he has gained due to his position in the corporation, the fraud occurs from trading on information to which the other party does not have access. The fraud is on the other party in the transaction. *Chiarella*, 445 U.S. at 227-28.

information for personal gain.²⁶ The misappropriation theory encompasses schemes which the traditional duty to abstain or disclose theory did not cover.²⁷

The misappropriation theory was before the court in *Chiarella*, but the majority did not address the issue because of a faulty jury instruction which failed to specify the affirmative duty to disclose before trading.²⁸ *Chiarella*, a printer, handled takeover bid announcements. The documents delivered to the printer concealed the identities of the target companies.²⁹ *Chiarella* determined the names of those companies from other information in the documents.³⁰ *Chiarella* then purchased stock in the target companies and sold the shares immediately after the takeover attempts became public.³¹

The Court reversed *Chiarella's* conviction, refusing to recognize "a general duty between all participants in market transactions to forgo actions based on material, nonpublic information."³² The majority held that there can be no duty to disclose where the person who has traded on inside information was not the corporation's agent, fiduciary, or person in whom the sellers of the securities had placed their trust and confidence.³³ In Justice Stevens' concurring opinion he stated that identification of a duty is necessary for liability to be imposed for a Rule 10b-5 violation.³⁴ Stevens agreed with the majority but established two duties³⁵ which *Chiarella* arguably violated: (a) a duty to disclose owed to the sellers from whom he purchased target company stock and (b) a duty of silence owed to the acquiring companies.³⁶

The dissenting opinions strongly supported the misappropriation theory. Chief Justice Burger's dissent presented the misappropriation theory before the Court for the first time by stating "that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."³⁷ He further stated "[a]n investor who purchases securities on the basis of misappropriated non-

26. *Chiarella*, 445 U.S. at 241 (Burger, C.J. dissenting).

27. The traditional duty to abstain or disclose theory relates primarily to inside traders. In such cases as *Carpenter*, no duty to disclose exists because the defendants are not trading on the inside information obtained from their positions as corporate insiders.

28. *Chiarella*, 445 U.S. at 231.

29. *Id.* at 224.

30. *Id.*

31. *Id.*

32. *Id.* at 233. A jury instruction failed to specify an affirmative duty to disclose in certain fiduciary relationships; therefore, the jury convicted *Chiarella* on a general duty of equal information access between all investors. This incorrect instruction compelled the Court to reverse *Chiarella's* conviction. *Id.* at 236.

33. *Id.* at 232.

34. *Id.* at 237 (Stevens, J., concurring).

35. The duties Justice Stevens established are not considered the traditional duty owed between the employee and employer. Stevens went outside the employee-employer realm and established *Chiarella* arguably had a duty to the sellers of the stock which he purchased and also a duty to the companies being acquired by the takeover. *Id.*

36. *Id.*

37. *Id.* at 240 (Burger, C.J., dissenting).

public information possesses just such an 'undue' trading advantage; his conduct quite clearly serves no useful function except his own enrichment at the expense of others."³⁸ Justice Brennan concurred with Chief Justice Burger on the substance of the misappropriation theory.³⁹

Justice Blackmun's dissenting opinion, in which Justice Marshall joined, agreed the scope of liability included "persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities."⁴⁰

In *Dirks v. SEC*,⁴¹ the Court considered a violation of Rule 10b-5 by a "tippee."⁴² A "tippee" receives information from an insider who breached a trust relationship.⁴³ Dirks was an officer of a New York broker-dealer firm who specialized in providing investment analysis to institutional investors.⁴⁴ Dirks received information from a former officer of Equity Funding of America alleging the assets of the company were vastly overstated due to fraudulent corporate practices.⁴⁵ As Dirks began to investigate the allegations, he also advised clients and investors of this information.⁴⁶ Due to Dirks' advice, five investment advisors liquidated holdings of more than \$16 million in Equity Funding of America.⁴⁷ After the stock price fell from twenty-six dollars per share to sixteen dollars per share, the California insurance authorities investigated and uncovered evidence of fraud at the company.⁴⁸ The lower court convicted Dirks of aiding and abetting under insider trading Rule 10b-5.⁴⁹

The Supreme Court reversed, holding that Dirks had "no duty to abstain from use of the inside information."⁵⁰ The Court reaffirmed its position in *Chiarella* that a duty to disclose arises from the relationship between the parties and not from one's ability to acquire information due to his position in the market.⁵¹

Justice Blackmun's dissenting opinion, joined by Justices Brennan and Marshall, found that personal gain is not a requirement of the breach

38. *Id.* at 241.

39. Justice Brennan concurred with the majority because the misappropriation theory was not presented to the jury. Brennan argued an adequate instruction was necessary in directing a verdict of guilty. *Id.* at 239 (Brennan, J., concurring).

40. *Id.* at 251 (Blackmun, J., dissenting).

41. 463 U.S. 646 (1983).

42. The introduction of the "tippee" into the insider trading scheme complicates matters. A "tippee" is outside the corporation but trades on information from an insider. At issue is the duty to disclose or abstain from trading of the insider transferring to the "tippee." *Dirks*, 463 U.S. at 655.

43. BLACK'S LAW DICTIONARY 1330 (5th ed. 1979).

44. *Dirks*, 463 U.S. at 648.

45. *Id.* at 649.

46. *Id.* at 648.

47. *Id.* at 649.

48. *Id.* at 650.

49. *Id.* at 651.

50. *Id.* at 667.

51. *Id.* at 658 (citing *Chiarella*, 445 U.S. at 231-232 n. 14).

of duty to disclose.⁵² Regardless of Dirks' motives, the misuse of material nonpublic information injured shareholders.⁵³

The United States Supreme Court failed to address the viability of the misappropriation theory in *Chiarella*⁵⁴ and *Dirks*.⁵⁵ In *Carpenter*, the theory was once again before the Court, and once again, due to an evenly divided decision,⁵⁶ the legitimacy of the misappropriation theory will be left for another day.

PRINCIPAL CASE

In the New York District Court, the defendants were charged with participating in a scheme to trade in securities based on information misappropriated from the *WSJ*.⁵⁷ The information Winans allegedly stole from the *WSJ* was the timing, content, and tenor of market-sensitive stories scheduled to appear in the *WSJ*.⁵⁸ Indictments were brought under sections 10(b)⁵⁹ and 32 of the Securities Exchange Act of 1934, 15 U.S.C. sections 78j(b), 78ff, and Rule 10b-5, 17 C.F.R. section 240.10b-5,⁶⁰ and the federal mail and wire fraud statutes 18 U.S.C. sections 1341, 1343.⁶¹

The district court held that Winans and Felis violated section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 by employing devices and schemes to defraud, and engaging in a course of business which operated as a fraud and deceit on the *WSJ* and Dow Jones, the parent company of the *WSJ*.⁶² Each was found to have done so by means of interstate commerce, the mails, and facilities of national securities exchanges in connection with the purchase or sale of securities.⁶³ In addition the defendants were found guilty of federal mail and wire fraud.⁶⁴

The case was appealed to the Second Circuit Court of Appeals.⁶⁵ Appellants contended that they could not be held liable for violating the securities laws because they were not corporate insiders or "quasi-insiders"⁶⁶ and did not misappropriate such material nonpublic information from such insiders or "quasi-insiders."⁶⁷

52. *Dirks*, 463 U.S. at 674 (Blackmun, J., dissenting).

53. *Id.*

54. 445 U.S. 222.

55. 463 U.S. 674.

56. *Carpenter*, 108 S. Ct. at 320.

57. *Winans*, 612 F. Supp. at 829.

58. *Id.*

59. *Supra* note 12.

60. *Supra* note 13.

61. *Supra* notes 14 and 15.

62. *Winans*, 612 F. Supp. at 849.

63. *Id.*

64. *Id.* at 850.

65. *Carpenter*, 791 F.2d 1024.

66. Quasi-insider refers to those individuals who are not normally part of the corporate structure but who have access to material nonpublic information. Quasi-insider would include bankers, accountants, and attorneys. *Winans*, 612 F. Supp. at 841 (citing *Dirks*, 463 U.S. at 655 n. 14).

67. *Carpenter*, 791 F.2d at 1025-26.

The court broadly interpreted the securities laws and the misappropriation theory in order to affirm the convictions.⁶⁸ The court looked to the plain meaning of the words and congressional intent in developing such a broad interpretation. First, the court indicated that securities laws should be construed flexibly to combat fraud.⁶⁹ In addition, the court reasoned that the repetition of the word "any" in 10b-5 showed Congress' intent to draft the rule broadly.⁷⁰ Finally, the court reasoned, section 10 (b) of the 1934 Act was designed to be a "catchall" clause to prevent fraudulent practice.⁷¹

The Second Circuit stated "one may not gain such [trading] advantage by conduct constituting secreting, stealing, purloining or otherwise misappropriating material nonpublic information in breach of an employer-imposed fiduciary duty of confidentiality."⁷² The court found the sole purpose of the scheme was the purchase and sale of securities, and thereby receiving instant no-risk profits in the stock market.⁷³

The case was appealed, and the United States Supreme Court granted certiorari.⁷⁴ The Court affirmed the judgment on the securities laws by an evenly divided court, and affirmed unanimously on the mail and wire fraud.⁷⁵ The opinion contains no discussion of the securities laws issues.⁷⁶

ANALYSIS

The misappropriation theory is an alternative method of imposing liability in connection with securities transactions. Due to the corporate structure securities laws were originally directed at officers, directors, or employees of a corporation that used material nonpublic information to make a no-risk profit. The securities exchanges and the traders have become more sophisticated; correspondingly, the schemes to obtain a no-risk profit have also become more sophisticated. By enforcing the securities laws only against the traditional insider, a door is left open for "outsiders" who use material nonpublic information to reap a harvest of no-risk profit.

"In construing the Rule's meaning, we must begin with its language."⁷⁷ Rule 10b-5 states that:

68. *Id.* at 1031.

69. *Id.* at 1029 (citing *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386-87 (1983)).

70. *Carpenter*, 791 F.2d at 1030 (citing *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972)).

71. *Carpenter*, 791 F.2d at 1030 (citing *Chiarella*, 445 U.S. at 226.).

72. *Carpenter*, 791 F.2d at 1031.

73. *Id.* at 1033.

74. 108 S. Ct. 316 (1987).

75. *Id.* at 316. The unanimous affirmation of the mail and wire fraud charges opens up the prosecution of white collar crimes such as insider trading regardless of what securities laws may or may not pertain.

76. Generally, the Court does not write an opinion where affirmance is by an equally divided vote; the Court merely issues a *per curiam* opinion. 12 J. MOORE, *supra* note 11.

77. *Carpenter*, 791 F.2d at 1029; *Chiarella*, 445 U.S. at 226.

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 national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of 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 as a fraud or deceit upon any person, in connection with the purchase or sale of any security.⁷⁸

The repetition of the word "any" throughout the Rule evidences a broad interpretation of the Rule.⁷⁹ The Rule refers specifically to schemes, untrue statements, and fraudulent practices in connection with the purchase or sale of any security. The illegal scenarios are numerous in Rule 10b-5 covering various illegal activities. In addition, the words do not limit the liability to trading on information gained through the traditional insider. This broad language suggests that congressional concern was the misuse of nonpublic information in trading securities.⁸⁰

The misappropriation theory's misuse of material nonpublic information could easily fit in the language of section 10b-5(a). The misuse of the information could be a scheme to defraud as in *Carpenter*.⁸¹ The *Carpenter* scheme defrauded the *WSJ* and the Dow Jones Co. by using the information entrusted to Winans concerning the timing and contents of the "Heard" article.⁸² The reputation of the *WSJ* and the integrity of the financial articles were injured when Winans' scheme was uncovered. Winans had a duty to *WSJ* not to disclose that information owned by the *WSJ* and the Dow Jones Co. for a personal benefit.⁸³

As Congress has recognized, the securities laws' purpose is "to assure that dealing in securities is fair and without undue preferences or advantages among investors." ⁸⁴ The misappropriation theory equalizes the information available to be used in trading securities by disallowing the use of misappropriated nonpublic materials. In broadening the trading schemes encompassed under the securities laws, the investors have a greater chance of playing on a level field. Congress intended the 1934 Act to protect the "perception of fairness and integrity in the securities markets."⁸⁵ The misappropriation theory furthers the legislative intent by giving the security laws a broad base of liability in order to halt fraudulent schemes. The stock market operates as a competitive auction in which

78. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1987).

79. *Affiliated Ute Citizens*, 406 U.S. at 151.

80. *Chiarella*, 445 U.S. at 240.

81. 108 S. Ct. 316 (1987).

82. *Id.* at 319.

83. *Supra* note 3.

84. *Chiarella*, 445 U.S. at 248 (Blackmun, J., dissenting) (citing H.R. CONF. REP. NO. 94-229 p. 91 (1975), U.S. CODE CONG. & ADMIN. NEWS 1975, p. 323).

85. *Carpenter*, 791 F.2d at 1030.

buyers and sellers around the world participate. Stock prices should reflect market conditions, such as the financial stability of the company and the potential growth or decline of its size. The market price should reflect the value of the stock as it is judged by market participants.⁸⁶ Realistically, all participants do not have equal access or availability of information. The misappropriation theory would punish traders using information that should legitimately be available to the market as a whole.

The small investor is at a great disadvantage by trading on the stock exchanges, and that disadvantage increases dramatically when other participants manipulate the price to a point where the price no longer reflects the company's actual worth. The small investor needs protection from schemes devised by such people as Winans. That protection comes from laws which are broad enough to prevent manipulation of prices in which a few make a quick buck. The harm to the investor is the proper concern of the securities laws.⁸⁷ Investors are equally harmed by the fraud of non-insider misappropriators as by the fraud of insiders.⁸⁸

Winans and his accomplices participated in a scheme in which they made approximately \$690,000 profit over four months.⁸⁹ This profit was virtually risk free. They knew the "Heard" column had an impact on stock prices. They were able to get a jump on trading the stock before other market participants received the same information. These types of schemes give the small minority of traders no-risk profits.

The securities exchanges are a vital part of the United States' and the world's economies. The markets must remain "free" markets in which investments are encouraged and not hindered by concerns of the exchanges being "fixed" by trading schemes. A free and open public market is built upon the idea that competing judgments of buyers and sellers, concerning the fair price of the security, bring about a fair market price.⁹⁰ The securities laws' ability to prevent unfair trading will provide stability and integrity to the stock markets.

CONCLUSION

The securities laws were developed to protect investors from undue preference or advantages by other participants. Investors are equally harmed by the fraud of non-inside misappropriators as by the fraud of insiders. The misappropriation theory would provide a method to punish traders using schemes that prior decisions under the securities laws do not cover. The courts should have the misappropriation theory available to fulfill the purpose of the securities laws; protection of all market investors.

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86. R. AUERBACH, *FINANCIAL MARKETS AND INSTITUTIONS*, p. 34 (1983).

87. *Carpenter*, 791 F.2d at 1032.

88. *Id.*

89. *Carpenter*, 108 S. Ct. at 319.

90. *Texas Gulf Sulphur Co.*, 401 F.2d at 858.