No. 78-1202

In the Supreme Court of the United States

OCTOBER TERM, 1978

VINCENT F. CHIARELLA, PETITIONER

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A34) is reported at 588 F.2d 1358. The opinion of the district court denying petitioner's motion to dismiss the indictment (Pet. App. B1-B3) is reported at 450 F. Supp. 95.

JURISDICTION

The judgment of the court of appeals was entered on November 29, 1978. A petition for rehearing was denied on January 4, 1979. The petition for a writ of certiorari was filed on February 2, 1979, and was granted on May 14, 1979. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether petitioner's purchase of securities based on material non-public information converted from the customers of the financial printing firm that employed him violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.
2. Whether petitioner had fair notice that his conduct was prohibited by Section 10(b) and Rule 10b-5.
3. Whether the district court's instructions to the jury on mens rea were correct.
4. Whether the district court correctly received in evidence an admission by petitioner that was privileged under state, but not federal, law.

STATUTES AND RULE INVOLVED

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

Section 32 of the Securities Exchange Act of 1934, 15 U.S.C. 78ff, provides in pertinent part:

> (a) Any person who willfully violates any provision of this chapter, or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter * * * shall upon conviction be fined not more than $10,000, or imprisoned not more than five years, or both * * * but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation.

Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. 240.10b-5, provides in pertinent part:

> 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, [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.

STATEMENT

1. Following a jury trial in the United States District Court for the Southern District of New York, petitioner was convicted on 17 counts of securities fraud, in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and SEC Rule 10b-5 promulgated thereunder, 17 C.F.R. 240.10b-5. The district court sentenced petitioner to concurrent terms of one year's imprisonment on counts 1 through 13 of the indictment, all but one month of which was suspended. Imposition of sentence was suspended on the last four counts, and petitioner was placed on five years' probation (Pet. App. A6 n.7).[1]

The evidence showed that petitioner worked for more than 20 years at Pandick Press, a financial printing firm located in New York City, rising from the level of linotype operator and copy cutter to become a mark-up man earning over $22,000 per year (Tr. 182-186). Pandick Press provided financial printing services for investment bankers, law firms, and corporations. It frequently prepared prospectuses, registration statements, offering circulars and other documents used to disclose material facts to the investing public as required under the federal securities laws (Tr. 283). As a mark-up man, petitioner was virtually the first person in the composing room to

[1] Petitioner's actions were also the subject of a civil enforcement proceeding filed by the SEC. Petitioner consented to a final order that permanently enjoined him from future violations of Sections 10(b) and 14(e) of the Securities Exchange Act and SEC Rule 10b-5. He also agreed to disgorge the profits resulting from his illegal activities. *SEC* v. *Chiarella*, SEC Litigation Release No. 7935 (May 25, 1977).

handle the documents of Pandick's customers (Tr. 181-182).

Because of the highly confidential nature of much of Pandick's financial printing business (Tr. 284-290, 344-345), the firm had a long-standing rule forbidding employees to disclose or use for personal advantage any information contained in documents submitted by customers (Tr. 190). In the summer of 1975, following the filing of an SEC injunctive proceeding against another printing firm as a result of misuse of non-public information contained in draft tender offer prospectuses, Pandick Press formally warned its employees that misuse of information contained in customer documents was both improper and illegal (Tr. 200-212, 285-287; Gov. Ex. 54).[2] Pandick Press posted 8″ by 10″ notices in large, bold-face print, stating the following (Tr. 200; Gov. Ex. 14A):

> TO ALL EMPLOYEES:
>
> The information contained in all type set and printing done by Pandick Press, Inc., is the private and personal property of the customer.
>
> You are forbidden to use any information learned from customer's copy, proofs or printed jobs for your own or anyone else's benefit, friend or family or talking about it except to give or

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[2] The complaint in *SEC* v. *Sorg Printing Co.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,767 (S.D. N.Y.), filed on August 21, 1974, charged that several employees at Sorg had violated Section 10(b) and Rule 10b-5 by using material non-public information concerning forthcoming tender offers to purchase the securities of target companies.

> receive instructions. Any violation of this rule will result in your being fired immediately and without warning.
>
> In addition, you are liable to criminal penalties of 5 years in jail and $10,000 fine for each offense.
>
> If you see or hear anybody violating this, report it immediately to your supervisor or to Mr. Green or Mr. Fertig. Failure to report violations will result in your being fired.

These large warning notices were posted by the punch clock that petitioner used every day and in the hallway leading from the elevator to the composing room where he worked (Tr. 206-210; Gov. Ex. 13). Pandick also posted additional warning signs on its bulletin boards, distributed warnings in pay envelopes sent to all employees, and printed warnings on the back of the employees' punch cards (Gov. Exs. 15, 16, 17; Tr. 201-202). To assure further that this message was conveyed, Pandick distributed warning cards to all of its employees and requested that they sign and return them (Tr. 202, 286, 525-529; Gov. Exs. 18, 64).[3]

In addition to working at Pandick Press, petitioner was an active stock market trader (Tr. 472). He communicated with his broker between 10 and 15 times per day (Tr. 473), studied financial literature, and, when possible, watched the "ticker" at his broker's office (Tr. 474). Based on the confidential information available to him at Pandick Press, pe-

[3] The text of the warning cards appears in the Appendix, *infra*.

titioner devised a scheme to improve his returns in the stock market. The scheme involved ascertaining the identities of companies subject to forthcoming tender offers or acquisitions through use of the confidential documents entrusted to him by the customers of Pandick Press. Because the customers submitted tender offer draft prospectuses with the names of the target corporations left blank or in code, petitioner went to extraordinary lengths to determine the identities of the target companies.[4] He did this by making note of facts contained in draft prospectuses, such as the market on which the stock was traded, the number of outstanding shares, the par value of the stock, and the high and low bids for the preceding year, and comparing the information with that contained in stock guide books he had obtained from his broker (Gov. Exs. 11A, 11B, 11C, 11D). Petitioner admitted to another employee at Pandick Press that he used this technique to determine the identities of target corporations and that he purchased stock on the basis of the non-public information he learned (Tr. 353-354).

Between September 1975 and November 1976, petitioner purchased the stock of five target companies whose identities he discovered by deciphering confidential material submitted by customers of Pandick

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[4] In order to preserve strict confidentiality, the offering corporation would either use a fictitious name for itself and its target or would leave that information blank with sufficient space to permit the type to be set accurately at the last minute. See Pet. App. A3; Gov. Exs. 22-1, 23A, 28, 31, 34, 38, 60.

Press (Gov. Exs. 60, 61, 62; Tr. 394-399). Petitioner telephoned his broker and instructed him to purchase stock in each of the target companies for his margin account (Gov. Exs. 6, 7, 10, 61; Tr. 75, 117-119). As a result of those orders, petitioner received confirmations of purchase by mail.[5] Petitioner told his broker that he was buying the stocks to make a quick profit (Tr. 102). He did not disclose to his broker or any seller, however, that he had based his investment decisions on confidential information obtained covertly from customers of Pandick Press (Tr. 74, 96, 103, 114, 353-354).

Within days or hours after petitioner purchased the stock, the offering companies publicly announced their take-over plans (Gov. Exs. 50, 51, 52, 53, 44, 45, 46, 47A, 48). The price of the stock of the target companies rose sharply. Petitioner sold out immediately thereafter, realizing over $30,000 in profits (Gov. Exs. 7, 10, 61).[6]

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[5] Each count of the indictment charged that petitioner used the facilities of interstate commerce in furtherance of his scheme by causing confirmation slips to be sent through the mails by his broker. The indictment focused on petitioner's purchase of stocks issued by five different companies: Counts 1-2 (USM Corp.); Counts 3-10 (Riviana Foods, Inc.); Counts 11-12 (Foodtown Stores, Inc.); Count 13 (Booth Newspapers, Inc.); Counts 14-17 (Sprague Electric Co.).

[6] All of the companies whose stocks petitioner purchased were subject to tender offers, except for Riviana Foods, which was involved in a negotiated merger. Petitioner's purchases and sales involved as many as 3200 shares on one occasion, 2300 shares on another occasion, and 1100 shares on another (Pet. App. A4 n.3).

Petitioner's purchases of the target stocks represented, in some cases, a substantial portion of the total daily trading in those stocks. For example, his purchase of Riviana Foods, Inc., on February 6, 1976, amounted to approximately one-half of the total volume of the company's stock traded that day (Tr. 421). Similarly, his purchase of Foodtown Stores, Inc., on October 11, 1976, amounted to one-half of the total trading volume (*ibid.*). None of the persons who sold their stock to petitioner knew that the companies were about to become the targets of tender offers or mergers (Tr. 353). The information concerning the forthcoming acquisitions was material information that would have affected the investment decision of those sellers (*ibid.*).[7] Investors who had sold their stock to petitioner testified that they would not have done so if they had been told that the issuer companies were about to become merger partners or targets of tender offers (Tr. 360, 372, 375, 384).[8]

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[7] Petitioner stipulated as follows (Tr. 353):

> If called as witnesses to testify at trial, the sellers of the shares of common stock listed in the indictment from whom Chiarella purchased the stock and any intermediary brokers would testify that they did not know that the company's stock they were selling was about to be the subject of a tender offer or merger.

Because acquiring firms typically offer a premium to stockholders to obtain their shares, the imminence of a tender offer or merger is a material fact, as petitioner stipulated (*ibid.*):

> It is further stipulated that information concerning upcoming tender offers or mergers is material.

[8] One of the sellers, an employee of one of the target companies (Sprague Electric Co.), testified that he noticed that the price of the company's stock was rising prior to the

Petitioner was the only defense witness. He admitted that he had ascertained the names of the target companies by using the confidential documents submitted by Pandick's customers and had purchased the securities described in the indictment on that basis (Tr. 474-477).[9] Although petitioner denied that he intended to defraud anyone (Tr. 483-484) and asserted that his actions were no different from those of tender offerors who purchase limited quantities of stock on the open market without disclosure (Tr. 491-492), petitioner acknowledged that he knew that "it was wrong to use confidential information for personal gain" (Tr. 497; see also Tr. 495-496, 498, 500-502, 509, 512) and that such use could lead to discharge (Tr. 479-480, 495). When confronted on cross examination with the large warning signs at Pandick Press describing applicable criminal penalties, petitioner testified that he had never read

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announcement of the tender offer and shortly after his sale. He inquired within his company about the reason for the price rise, but the vice president of the company replied that he did not know (Tr. 362-363). Another seller, who was a professional security analyst, sold shares of USM Corporation to petitioner shortly before announcement of the tender offer. He testified that, despite his professional training, he was unable to perceive that a tender offer was imminent on the basis of available public information (Tr. 369-372).

[9] Petitioner stipulated that the mails were used in conjunction with these transactions (March 1978 stipulation, ¶¶ 1, 2). He further stipulated that he "did not tell anyone or communicate any information he may have had regarding the subject of a tender offer or merger in connection with the purchases of stock listed in the indictment" (*id.* at ¶ 4(a)).

the signs even though he had passed them more than 640 times (Tr. 502-508).[10]

Petitioner testified that he realized that he had been fired by Pandick Press "because I was using insider's information" (Tr. 514).[11] When asked whether he knew that it was against the law to trade on the basis of insider information, he said, "I didn't know it was a criminal law. * * * It was a violation, as far as I knew" (Tr. 515). When pressed on that point, petitioner admitted that he realized that use of insider information "was against the SEC" (Tr. 516).[12]

2. The district court instructed the jury that before it could return a verdict of guilty it must find beyond a reasonable doubt that petitioner employed a device, scheme, or artifice to defraud, or engaged in an act, practice or course of business that operated or would operate as a fraud or a deceit, as charged in the indictment; that petitioner did so knowingly and

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[10] At petitioner's sentencing hearing, the district court characterized that testimony as "perjury beyond a reasonable doubt" (Pet. App. A17 n.18).

[11] When petitioner was discharged for trading on the basis of confidential information, he did not protest but simply said: "I understand" (Tr. 234-235).

[12] Petitioner also admitted having read about insider trading cases in the newspaper (Tr. 518):

Q. You also knew that it was wrong against SEC rules to use inside information, is that right?

A. What I read in the papers, cases that I have.

Q. So the answer is yes?

A. Yes.

willfully; that the fraudulent conduct occurred in connection with a purchase or sale of securities; and that the mails were used in furtherance of the fraudulent scheme (Tr. 681-683). The court further instructed the jury that, to sustain a charge of fraudulent trading on the basis of material non-public information, the jury would have to find beyond a reasonable doubt both that the information was non-public and that it was not disclosed in connection with the stock transaction (Tr. 685-686).

The court defined "willful and knowing" conduct for the jury, stressing that such conduct is voluntary, intentional and deliberate and not a result of "innocent mistakes, negligence or inadvertence" (Tr. 688). The court added that the government must prove (*ibid.*):

> a realization on the defendant's part that he was doing a wrongful act, * * * and that the knowingly wrongful act involved a significant risk of effecting the violation that occurred.

The court also told the jury that evidence admitted during trial showing that certain tender offerors sometimes buy securities on the open market before filing disclosure statements may be considered in determining whether petitioner acted with the understanding that his conduct was wrongful (Tr. 689). It pointed out in this connection (Tr. 692):

> The central issue I suggest to you is what was Mr. Chiarella's state of mind when he was engaged in any one of them, using the clues and decoding the information, as he testified, know-

> ing that this violated company policy? Did he have any realization that he was doing a wrongful act or did he not? Did he believe that because he had an awareness a corporation could properly purchase stock in a target company without revealing its intent to make a tender offer, that he could under the circumstances figure out the target companies' names and purchase their stock for his own personal gain without its being a wrongful act on his part?

The jury subsequently returned its verdict of guilty on all 17 counts of the indictment (Pet. App. A6).

3. The court of appeals affirmed the judgment of conviction, one judge dissenting (Pet. App. A1-A34). The court held that petitioner's secret conversion of information provided in confidence by the acquiring companies, and his use of that information to purchase securities, operated as a fraud on the acquiring companies (*id.* at A13 & n.14). The court underscored the importance to acquiring companies of preserving the secrecy of their acquisition plans and avoiding trading or leaks that could cause "an anticipatory rise in the market price of the target company's stock" (*id.* at A3, A12-A13). The court also held that petitioner's use of confidential information converted from the acquiring companies operated as a fraud on the persons who sold him securities (*id.* at A6-A9).

The court of appeals concluded that, in these circumstances, petitioner was under a duty either to abstain from trading or to await public disclosure of the information before purchasing securities from uninformed investors (Pet. App. A6-A9). While the court did not hold "that no one may trade on non-public market information without incurring a duty to disclose" (*id.* at A10), it concluded that such a duty applied to petitioner, who had "converted to his personal use confidential information entrusted to him in the course of his employment" (*id.* at A13). The court added that "[i]t is difficult to imagine conduct less useful, or more destructive of public confidence in the integrity of our securities markets, than Chiarella's" (*id.* at A15).

The court of appeals rejected petitioner's contention that he did not receive fair notice that his conduct violated Section 10(b) and Rule 10b-5. It noted that although "the precise fact pattern at issue here" had not been addressed in prior decisions (Pet. App. A15), imposition of liability was a logical and predictable application of prior authorities, and that the SEC's earlier charges of antifraud violations by other printers engaged in identical practices provided substantial warning. The court pointed out that petitioner received additional notice of potential criminal liability by the posters that were placed throughout the premises of Pandick Press, observing that "[f]ew malefactors receive such explicit warning of the consequences of their conduct" (*id.* at A17).

The court also ruled that the charge to the jury concerning petitioner's state of mind complied with this Court's holding in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) (Pet. App. A17-A20). It observed that *Hochfelder* had established that the scienter requirement of Section 10(b) and Rule 10b-5 precluded imposition of liability in a private action for damages on the basis of negligent misstatements or omissions. That holding, the court reasoned, does not bar a criminal conviction where the government proves a willful and knowing scheme to defraud, undertaken with the realization that the behavior in question is wrongful.

Judge Meskill dissented, concluding that application of the "disclose or abstain" doctrine to persons in petitioner's position was a departure from prior law. In his view, petitioner did not "owe[] a duty of disclosure to the sellers of target stock" (Pet. App. A29), and any breach of duty owed to the acquiring companies whose information petitioner admittedly converted constituted a mere breach of fiduciary duty, not fraud (*ibid.*). Judge Meskill concluded that a criminal prosecution in the circumstances of the present case violated principles of due process, since "fair notice" of potential liability did not emanate "from the language of the statute itself, from prior judicial interpretation, or from established custom and usage" (*id.* at A32).

SUMMARY OF ARGUMENT

I.

Section 10(b) of the Securities Exchange Act, 15 U.S.C. 78j(b), proscribes any deceptive device or contrivance used in connection with a Securities purchase or sale if prohibited by the rules of the Securities and Exchange Commission. SEC Rule 10b-5, 17 C.F.R. 240.10b-5, broadly prohibits the use in connection with a securities transaction of any device, scheme, or artifice to defraud, or any practice that operates or would operate as a fraud on any person. Congress intended Section 10(b) to serve as a "catch-all." The statute reaches all new "cunning devices" used to commit fraud, especially those devices that "fulfill no useful function." *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 203-206 (1976). As this Court has frequently noted, Congress enacted the anti-fraud provisions of the federal securities laws " 'to achieve a high standard of business ethics . . . *in every facet of the securities industry.*' " *United States* v. *Naftalin*, No. 78-561 (May 21, 1979), slip op. 6 (emphasis in original).

1. Petitioner violated Section 10(b) and Rule 10b-5 by converting confidential information belonging to the customers of his printing firm and using that information for personal enrichment in the stock market. His secret misappropriation operated as a fraud on the businesses that entrusted him with that information. The court of appeals properly characterized petitioner's conduct as "conversion"; in the words of the district court, it was equivalent to "embezzlement" (Pet. App. A13, B2).

Misuse of confidential information concerning impending tender offers and acquisitions can disturb market prices and prematurely reveal acquisition plans, contrary to the interests of the acquiring companies. Thus, petitioner's misappropriation placed his interests in direct conflict with those of the acquiring companies to whom he owed a duty of confidence. As their agent, petitioner had an obligation to disclose his actions. Under common law principles, failure of an agent to disclose self-dealing or conflicts of interest affecting the subject matter of the agency is a form of deceit. It also violates Section 10(b) and Rule 10b-5 where, as in this case, the agent's fraud occurs in connection with a securities purchase or sale. Here, as in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 10-13 (1971), concealed misappropriation by a fiduciary, achieved through the vehicle of a securities transaction, constitutes a violation of the statute and the rule.

2. Petitioner's use of converted information for personal financial gain also operated as a fraud on the uninformed investors who sold him securities. At common law, a purchaser was not privileged to take advantage of a seller by use of material information inaccessible to the seller if that information was obtained through unlawful methods. The rule of *caveat emptor*, which was designed to reward astuteness and penalize heedlessness, did not apply to exploitation of uninformed sellers through converted information that the seller, no matter how diligent, could not have lawfully obtained.

Moreover, under the federal securities laws the "philosophy of full disclosure" long ago superseded that of "*caveat emptor.*" See *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972). Consistent with this statutory philosophy, the decisions of the lower courts have uniformly held that persons who misappropriate confidential commercial information and who use that information for personal enrichment in the stock market infringe the statute and the rule. See, *e.g.*, *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

The fact that petitioner's fraud involved the misappropriation of important information directly related to the market price of the securities that he purchased, rather than information about the earning power of the companies that issued those securities, underscores, rather than minimizes, the illegality of his actions. Foreknowledge of an acquisition or tender offer—events entailing a sudden and substantial increase in market values—is certain knowledge that the stock of the target company is worth significantly more than its owners believe. Obtaining that information by contrivance in order to exploit uninformed investors is an act of dishonesty and deception that the securities laws properly should and do condemn.

This Court's decision in *Affiliated Ute Citizens* v. *United States*, *supra*, establishes that the failure of purchasers to disclose to sellers important facts relating to the market price of securities can violate Section 10(b) and Rule 10b-5. The defendants in *Ute* bought securities based on information concerning their market price that the defendants obtained by virtue of their privileged position in the market place. Financial printers also occupy such a privileged position. Petitioner was entrusted with highly material and confidential information that would cause substantial unfairness and unjust preferences if selectively revealed or misused. It was his job to help prepare disclosure documents for dissemination to all investors on an equal basis. He perverted that function by using the information to enrich himself. His conduct is wholly at odds with "[t]he high standards of business morality" exacted by the federal securities laws. *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 201 (1963).

Petitioner's conduct bears no resemblance to that of tender offerors or other business firms that purchase securities (within statutory and regulatory limits) while in possession of information about market conditions generated by their own bona fide commercial activity. The securities laws have never been interpreted in such a manner as to preclude legitimate economic activity. Petitioner's conversion and misuse of material confidential information, by contrast, was harmful to the bona fide business activity of acquiring companies and to the investing public. His activities present a clear example of deceptive conduct that can "fulfill no useful function." *Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 204-205, 206.

II.

Petitioner received fair notice that his conduct could result in the imposition of criminal sanctions. The literal language of Section 10(b) and Rule 10b-5 placed him on notice that all deceptive devices and contrivances practiced in connection with a securities transaction violate the law. Prior to his actions, the lower courts repeatedly had denounced insider trading (*SEC* v. *Texas Gulf Sulphur Co.*, *supra*) and this Court had held that frauds involving the misuse of market information relating to the value of securities were forbidden (*Affiliated Ute Citizens* v. *United States, supra*). Lower court decisions had also established that use of information concerning impending corporate acquisitions to purchase target company stock violated the statute and the rule (*SEC* v. *Shapiro*, 494 F.2d 1301, 1303-1307 (2d Cir. 1974)). Similarly, the SEC had commenced well-publicized enforcement proceedings against printers who had misused confidential data concerning forthcoming tender offers (*SEC* v. *Sorg Printing Co.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,767 (S.D. N.Y. 1974)). Moreover, prior to petitioner's actions, the Department of Justice had instituted criminal prosecutions in many cases where willful violations of Section 10(b) and Rule 10b-5 were found to exist.

As the court of appeals pointed out, this case presents no abstract question concerning the sufficiency of notice provided by statute books and judicial opinions. Petitioner received explicit warning from large posters placed throughout his printing firm that use of confidential information for securities trading would subject him to fines and imprisonment. Few malefactors ever receive such specific and personal warning about the consequences of their actions.

Furthermore, the district court instructed the jury that it could not find petitioner guilty unless the government proved beyond a reasonable doubt that he acted willfully and knowingly with the understanding that his conduct was wrongful. Thus, there is no question here of convicting a defendant who believed that his actions were proper. This Court repeatedly has held that, where a defendant acts with *mens rea*, constitutional standards of fair notice are satisfied even if the prohibitory language of the statute is general or, indeed, even if the precise boundaries of the statute are subject to debate. Where a defendant consciously acts in a manner that he knows to be wrongful, and where his conduct is fairly encompassed by the literal terms of the criminal statute, the Due Process Clause does not stand in the way of his conviction. See, *e.g.*, *Nash* v. *United States*, 229 U.S. 373, 377 (1913); cf. *United States* v. *United States Gypsum Co.*, 438 U.S. 422, 438-441 (1978) (defendants may be convicted of "rule of reason" violations under the antitrust laws where *mens rea* is proven).

III.

The district court's charge to the jury emphasized that it could not find petitioner guilty unless it concluded that he acted willfully and knowingly, with consciousness that his conduct was wrongful. The court specifically instructed the jury that it could not convict petitioner if his actions were merely negligent. That instruction comports in all respects with *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976). *Hochfelder* held that Section 10(b) and Rule 10b-5 require proof of scienter as opposed to simple negligence. The scienter standard is satisfied by proof of knowing and willful misconduct. At common law, knowing and willful conduct was equivalent to scienter. The lower courts uniformly have held that such proof satisfies the scienter standard adopted in *Hochfelder*.

The district court properly rejected petitioner's proposed instruction that the jury must find an "evil ambition to injure someone." That instruction not only misstates the law but also has no logical application in a case of this kind. Persons trading on the basis of material non-public information on impersonal securities exchanges are unaware of the identities of other traders. They rarely entertain an evil ambition to injure a victim. Their only intent is to make a profit and avoid detection. If criminal or civil sanctions are to be available in cases involving trading on material non-public information, the statute and the rule cannot be construed to require an evil ambition to injure some victim. Proof of knowing and willful misconduct, undertaken with a realization of its wrongfulness, is a sufficient showing of *mens rea* in a criminal prosecution of this kind. *United States* v. *United States Gypsum Co.*, *supra*, 438 U.S. at 443-446.

IV.

The district court's receipt of an admission made by petitioner to the New York Department of Labor did not constitute reversible error. Under New York law, the Department of Labor may disclose statements given in connection with unemployment insurance benefits in a number of different situations, and the Department discloses such statements to the FBI. Indeed, the New York Commissioner of Labor approved use of petitioner's admission in the present prosecution. Thus, receipt of this evidence did not infringe any state policy.

The federal policy in favor of admissibility is expressed in Fed. R. Evid. 402 and 501, which authorize the receipt of all relevant evidence in criminal trials unless barred by the Constitution, a federal statute, or the federal common law. No principle of federal constitutional, statutory, or common law requires exclusion here. In the circumstances of this case the district court properly declined to erect a new federal privilege. See *United States* v. *Nixon,* 418 U.S. 683, 708-713 (1974). Moreover, receipt of petitioner's admission, even if erroneous, was clearly harmless. The government proved the substance of the admission through independent and uncontradicted evidence. Receipt of this cumulative evidence could not have affected the outcome of the trial.

ARGUMENT

I. PETITIONER'S SECRET CONVERSION OF MATERIAL CONFIDENTIAL INFORMATION FROM THE CORPORATIONS THAT RETAINED HIS PRINTING FIRM, AND HIS USE OF THAT INFORMATION TO PURCHASE SECURITIES FROM UNINFORMED INVESTORS, VIOLATED SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SEC RULE 10b-5

Petitioner admits that he converted confidential information from the corporations that entrusted his printing firm with their documents (Br. 6-7) and that he used that information to purchase stock from unsuspecting investors (*ibid.*). He has stipulated that the information he converted was of material importance and that he made no disclosure to anyone before purchasing the securities (and then quickly reselling them at a large profit to himself) (see pages 9-10, *supra*). Petitioner contends, however, that his conduct cannot be deemed to be fraudulent under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), or Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, because he was not "an 'insider,' the 'tippee' of an 'insider', or one with a special relationship with other traders and investors" (Br. 13).

The court of appeals correctly rejected petitioner's contention, in recognition of the well established principal that Section 10(b) and Rule 10b-5 apply to "any" fraudulent scheme (*Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972)) and are not limited to frauds involving "inside" corporate information or trading between persons having an arbitrarily defined "special relationship." As this Court recently noted in *United States* v. *Naftalin*, No. 78-561 (May 21, 1979), slip op. 6, the antifraud provisions of the federal securities laws were intended " 'to achieve a high standard of business ethics . . . *in every facet of the securities industry*' " (emphasis in original). As we demonstrate below, petitioner committed fraud against both the acquiring corporations whose information he converted and the investors who sold him securities in ignorance of forthcoming market events of critical importance. Since petitioner's fraud occurred "in connection with" his purchase of securities, it constituted a violation of the statute and the rule.[13]

A. Section 10(b) And Rule 10b-5 Apply To Any Deceptive Practice Used In Connection With A Purchase Or Sale Of Securities, Not Just The Species Of Fraud Involving Insider Information Or A Special Relationship Between Buyer And Seller

In considering petitioner's assertions regarding the limited scope of Section 10(b) and Rule 10b-5, the primary guide must be the language of the statute and the rule. See *Touche Ross & Co.* v. *Redington*, No. 78-309 (June 18, 1979), slip op. 7 ("as with any case involving the interpretation of a statute, our analysis must begin with the language of the statute itself"); *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 472 (1977); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 197 (1976). The literal language of the statute and its implementing rule prohibits *all* frauds, not just certain categories of fraud. Section 10(b) provides that it is unlawful for "any person," "directly or indirectly," to "use or employ, in connection with the purchase or sale of any security * * * 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

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[13] This is a criminal prosecution brought by the United States to enforce the federal securities laws. It does not present the complications often involved in private actions, including questions of standing to sue and the scope of private redress. See *United States* v. *Naftalin, supra*, slip op. 5 n.6.

investors." Pursuant to this broad mandate, Rule 10b-5 prohibits the use of "any device, scheme or artifice to defraud," and also forbids any person "[t]o 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 a securities purchase or sale.

The statute and rule could hardly have employed broader terms. There is no limitation on the category of persons who may violate the statute or rule. Nor is there a limitation on the category of fraud or on the identity of the victim. The antifraud provisions apply to "any person" and extend to "any" fraudulent device or contrivance, whether practiced directly or indirectly. See *Affiliated Ute Citizens* v. *United States*, *supra*, 406 U.S. at 151 (footnote omitted):

> These proscriptions, by statute and rule, are broad and, by repeated use of the word "any," are obviously meant to be inclusive. The Court has said that the 1934 Act and its companion legislative enactments embrace a "fundamental purpose . . . 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."

Accord, *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 9-13 & n.7 (1971) (quoting *A. T. Brod & Co.* v. *Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)); *United States* v. *Naftalin*, *supra*, slip op. 3-8. Thus, the literal text of the statute and the rule provide no support for the argument that they should be limited to frauds practiced by "insiders" or "tippees," or to frauds involving a "special relationship" between buyer and seller.

Where a defendant's scheme to defraud involves "deception," "manipulation" or "non-disclosure," as opposed to simple breach of fiduciary duty (*Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 476 (1977)), is accompanied by "scienter" rather than negligence (*Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 214 (1976)), and involves the purchase or sale of securities and the facilities of interstate commerce, the broad prohibitions of Section 10(b) and Rule 10b-5 apply at face value. As this Court emphasized in *Hochfelder*, Section 10(b) was conceived as a "catch-all" to "deal with new manipulative or cunning devices." 425 U.S. at 203. Quoting from the remarks of Thomas Corcoran, a spokesman for the drafters of the legislation, the Court concisely summarized the statute's prohibition: " 'Thou shalt not devise any other cunning devices.' " *Id.* at 202. See also S. Rep. No. 792, 73d Cong., 2d Sess. 18 (1934) (Section 10(b) supplements narrower antifraud prohibitions by extending to "any other manipulative or deceptive practices"). Congress intended the antifraud prohibition to fall with special force on " 'manipulative and deceptive practices which . . . fulfill no useful function' " and on " 'illicit practices,' where the defendant has not acted in good faith." *Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 206. As Professor Loss has summarized, Section 10(b) was intended to serve as an "omnibus provision" to curtail all fraudulent schemes used in connection with securities transactions. VI L. Loss, *Securities Regulation* 3528 (1969 ed.). Accord, 1 A. Bromberg, *Securities Law Fraud: SEC Rule 10b-5*, § 2.2(332) (1977). In light of the broad "catchall" purposes of Section 10(b) and Rule 10b-5, there is no basis for petitioner's argument that the unusual nature of the fraud that he practiced provides immunity from liability.

B. Petitioner Defrauded The Corporations That Entrusted Him With Confidential Information When He Secretly Converted That Information And Used It For Personal Profit In The Stock Market

Petitioner's secret conversion of confidential information operated as a fraud on the corporations that entrusted him with that information. Because he practiced his scheme to defraud through securities purchases and sales, he violated Section 10(b) and Rule 10b-5.

The indictment in this case charged that petitioner's actions operated as a fraud on the sellers of the securities. It also charged that his conduct amounted to a device, scheme, or artifice to defraud, without limitation on the category of victims (Indictment, ¶ 1). Accordingly, in its pretrial order denying petitioner's motion to dismiss the indictment, the district court explained that, if proven, the scheme charged in the indictment would operate as a fraud on the corporations whose information petitioner converted (Pet. App. B2-B3):

> Crediting the indictment, there 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." * * * The analogy of embezzlement by a bank employee immediately springs to mind, and, of course, embezzlement implies fraudulent conduct. *E.g.*, *Grin* v. *Shine*, 187 U.S. 181, 189-90 * * * (1902). Chiarella can, therefore, hardly claim that the acts alleged did not operate as a fraud. * * * 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 cost 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.

In light of the uncontradicted evidence of undisclosed misappropriation of confidential information presented at trial, the prosecutor argued to the jury that petitioner's conduct constituted a fraud against the acquiring companies (Tr. 605).[14]

The court of appeals agreed with the district court that petitioner's conduct operated as a fraud on the tender offerors as well as the sellers of securities (Pet. App. A13 n.14):

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[14] The district court's charge to the jury emphasized that Section 10(b) and Rule 10b-5 could be violated by a fraud practiced on "any person" in connection with a purchase or sale of securities (Tr. 681, 683, 686-687). This phrase, like Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), contains no limitation on the category of persons who may

> [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.

The court also emphasized that petitioner's secret conversion and use of confidential information for market purchases threatened the offerors' interest in preventing an "anticipatory rise in the market price of the target company's stock" (*id.* at A3). As we demonstrate below, the district court and court of appeals correctly ruled that petitioner's conduct operated as a fraud on the acquiring corporations in violation of Section 10(b) and Rule 10b-5.

1. *Pre-announcement secrecy is essential to the success of tender offers*

As both of the courts below recognized, pre-announcement secrecy is essential to the success of a

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be victimized by a fraudulent scheme and reaches fraudulent practices aimed at businesses as well as individual investors. See *United States* v. *Naftalin, supra,* slip op. 6. Thus, the district court's charge permitted the jury to find that petitioner's conduct constituted a fraud upon both the acquiring companies and the investors who sold securities to petitioner.

tender offer or acquisition.[15] The corporations involved here used coded references in their draft prospectuses, or left the names of the target companies blank, to preserve strict confidentiality. Pandick Press recognized the importance of confidentiality by admonishing its employees that information contained in customer documents "is the private and personal property of the customer" and by prohibiting any disclosure or use of the information for private purposes (see pages 5-7, *supra*).

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, Pub. L. No. 90-439, 82 Stat. 454, witnesses pointed out that premature revelation of the acquiring company's plans can abort a tender offer. See, *e.g.*, testimony of Donald Calvin, Vice President of the New York Stock Exchange (*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)):

> Obviously, a company intending to make a tender offer strives to keep its plan secret. If

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[15] A tender offer consists of a bid by an individual or a group to buy shares of a corporation, usually at a price above the current market price. This premium has the effect of raising the market price of the target company's stock once the tender offer becomes publicly known.

> 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.

See also *id.* at 73-75. Other witnesses also mentioned the necessity to avoid rumors and leaks of information about imminent tender offers. See *id.* at 84, 87-89 (remarks of Philip West, Vice President, and Keith Funston, President of the New York Stock Exchange); 98, 105 (remarks of Ralph Saul, President of the American Stock Exchange); 151, 163 (remarks of Francis Schanck, Vice President of the Investment Bankers Association). See also Hayes & Taussig, *Tactics of Cash Takeover Bids*, 45 Harv. Bus. Rev. 135, 139-140 (1967).

In addition to the potential effect on price, leaks and unusual trading patterns may alert the target company to the tender offeror's plans. See A. Fleischer, *Tender Offers: Defenses, Responses, and Planning* 4-6 (1978). A target company alerted to a possible tender offer by unusual trading volume or rumors can commence communications with its shareholders to deflect the offer, can prepare for litigation against the offeror, and can attempt to find competing friendly bidders to defeat the offeror. See *id.* at 113-153. See also Hayes & Taussig, *supra*, 45 Harv. Bus. Rev. at 142-147; *Panel Discussion: Defending Target Companies*, 32 Bus. Law. 1349-1363 (special issue 1977). Of equally great importance, 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, if not total loss of the target company. See, *e.g.*, Troubh, *Purchased Affection: A Primer On Cash Tender Offers*, 54 Harv. Bus. Rev. 79, 83 (chart) (1976).

This "high drama of Wall Street," as the court of appeals observed, also has its "tedious aspects," particularly the vast amount of paper that must be generated before a tender offer is made (Pet. App. A2-A3). Therefore, to avoid unfavorable price behavior, defensive maneuvers by the target company, and competing bids, the tender offeror must select "[p]rinters * * * who are efficient as well as discreet * * *." Troubh, *supra*, 54 Harv. Bus. Rev. at 86. Far from being discreet, however, petitioner engaged in the very kind of behavior that was likely to frustrate the acquisition plans of Pandick's customers. As noted on pages 9-10, *supra*, petitioner's substantial trading in the stock of target companies represented one-half of the total volume of daily trading in two instances, and unexplained price rises in target shares were described by witnesses at trial. Moreover, petitioner's continuing communication with his broker and repeated purchases of large amounts of target company stock immediately prior to the announcement of the tender offers was the very kind of behavior that could serve as a tip to his broker and give rise to rumors of an offer.[16] This activity could easily have forewarned the target companies of the plans of the acquiring companies, to whom petitioner owed a duty of confidence.[17]

In sum, petitioner's secret conversion of confidential information and his use of that information for trading in the stock market placed him in a serious conflict of interest and posed a substantial threat to the interests of the customers of his printing firm.

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[16] Petitioner's broker was well aware that petitioner was employed in a financial printing firm (Tr. 70-74). The broker was also aware of petitioner's repeated success in picking tender offer targets immediately before the public announcement of the tender offers (Tr. 101-114). See generally *In re George Mayer*, Securities Exchange Act Release No. 84591 (1978) (customer trading alerts broker to non-public market information).

[17] See Fleischer, *supra*, at 4-5, pointing out that tender offer targets can protect themselves against take-over bids by "stock watch" programs focused on unusual trading activities and by alertness to information about possible tender offers available from brokerage houses. See also Reuben & Elden, *How To Be A Target Company*, 23 N.Y.L. Sch. L. Rev. 423, 429 (1978). Petitioner's use of confidential tender offer information was discovered by the New York Stock Exchange's stock watch personnel, who observed unusual trading patterns in the shares of one of the target companies. See *SEC* v. *Chiarella*, SEC Litigation Release No. 7935 (May 25, 1977).

2. *As an agent, petitioner was forbidden to engage in self-dealing affecting the subject matter of his agency without making full disclosure*

As a mark-up man at Pandick Press who received customer copy and who was aware of the need for confidentiality applicable to that copy, petitioner was subject to the rules of agency governing the preservation of confidences.[18] The rules of agency forbid an agent to place himself in a position of potential conflict with his principal, to earn secret profits through the agency, or to disclose or use for personal advantage any of the principal's confidential information. See II *Restatement of Agency* § 395 & Comments a and c, § 393 & Comment a, § 390 & Comment a, § 388, § 383 (1933). See also 1 F. Mechem, *Law of Agency* §§ 1189, 1191, 1209, 1224 (2d ed. 1914).

An agent contemplating a transaction that could infringe these rules has an unqualified duty to make prior disclosure to permit his principal to take steps to protect himself. See II *Restatement of Agency, supra,* at § 395 & Comment c, § 381 & Comment d, § 390 & Comment a, § 393 & Comment a. Accord, Mechem,

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[18] Because it assumed a fiduciary duty to use confidential information entrusted to it only for the purposes designated by its customers and acted under the control and for the benefit of those customers, Pandick Press occupied the position of an agent. See I *Restatement (Second) of Agency* § 14N (1958). Petitioner, an employee of Pandick Press with knowledge of the rule against using confidential information for personal benefit, was a sub-agent subject to identical fiduciary responsibilities. See Pet. App. A13 n.14; *id.* at A29 (Meskill, J., dissenting); II *Restatement of Agency* § 428 & Comment b; W. Seavey, *Agency* 10 (1964). See also Scott, *The Fiduciary Principle,* 37 Calif. L. Rev. 539, 540-541, 553-554 (1949); III J. Pomeroy, *Equity Jurisprudence* 793-796 (5th ed. 1941); 36A C.J.S. 382-389 (1961) (collecting cases).

supra, at §§ 1207, 1353. Nondisclosure by an agent or other fiduciary in such circumstances constitutes deceit. See, *e.g.*, III *Restatement of Torts* § 551(2) (a) & Comment e (1938); see also James & Gray, *Misrepresentation—Part II*, 37 Md. L. Rev. 488, 524-525 (1978); *Kerr on Fraud and Mistake* 185-186, 210-213 (7th ed. 1952); G. Bower, *The Law Relating to Actionable Non-Disclosure* 294-306 (1915).[19] Petitioner's contrivance to convert confidential information operated as a fraud on the companies that entrusted him with that information within these well-established principles.

3. *Petitioner's fraud occurred "in connection with" the purchase of securities and therefore violated the statute and the rule*

Because petitioner's scheme to defraud operated through his purchase of securities and also had a close

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[19] This Court has frequently held that an agent's failure to disclose self-dealing or conflicts of interest constitutes fraud. See, *e.g.*, *Sim* v. *Edenborn*, 242 U.S. 131 (1916); *Strong* v. *Repide*, 213 U.S. 419, 428-433 (1909); *United States* v. *Carter*, 217 U.S. 286, 305-310 (1910); *Wardell* v. *Railroad Company*, 103 U.S. 651, 654-659 (1880). The common law rule in the state courts is the same. See, *e.g.*, *Holland* v. *Moreton*, 10 Utah 2d 390, 396, 353 P.2d 989, 994 (1960); *Myers* v. *Linebarger*, 134 Ark. 231, 234, 203 S.W. 580, 581 (1918); *Allen* v. *Barhoff*, 90 Conn. 184, 187, 96 A. 928, 930 (1916); *Ericson* v. *Nebraska-Iowa Farm Inv. Co.*, 134 Neb. 391, 399, 278 N.W. 841, 845 (1938); *Doyen* v. *Bauer*, 211 Minn. 140, 145-148, 300 N.W. 451, 454-456 (1941). Moreover, as the district court noted (Pet. App. B2-B3), petitioner's secret conversion of the intangible property of the customers of Pandick Press bears the indicia of embezzlement, a crime that is inherently fraudulent. See, *e.g.*, *Grin* v. *Shine*, 187 U.S. 181, 189 (1902); W. LaFave & A. Scott, *Criminal Law* 644-645 (1972).

relationship with (and potentially injurious effect upon) the securities purchases of the acquiring companies, his fraud occurred "in connection with" securities transactions. It therefore violated Section 10(b) and Rule 10b-5.[20] As noted above, 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.*, 404 U.S. 6, 12-13 (1971). As the *Bankers Life* case illustrates, concealed embezzlement or conversion, achieved through the vehicle of a securities transaction, constitutes a variety of fraud prohibited by Section 10(b) and Rule 10b-5. See *id.* at 10-11 & n.7 ("misappropriation is a 'garden variety' type of fraud"); see also *Allico National Corp.* v. *Amalgamated Meat Cutters & Butcher Workmen of North America*, 397 F.2d 727, 728-730 (7th Cir. 1968); A. Jacobs, *The Impact of Rule 10b-5* § 67.02 (1978); cf. *A. T. Brod & Co.* v. *Perlow*, 375 F.2d 393, 397 (2d Cir. 1967).[21]

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

[21] See also *SEC* v. *Texas Gulf Sulphur Co.*, *supra*, 401 F.2d at 856 (self-dealing by agent officers of a corporation, who

Contrary to the assertion of the dissenting judge in the court below (Pet. App. A29), petitioner's secret conversion and use of confidential information was not merely a breach of fiduciary duty. Petitioner's conduct amounted to a breach of duty to be sure, but it also involved "some element of deception" (*Santa Fe Industries, Inc.* v. *Green, supra,* 430 U.S. at 475) —a material failure to disclose. And as this Court has noted, concealment, nondisclosure or deception in conjunction with a breach of fiduciary duty gives rise to a violation of Section 10(b) and Rule 10b-5. See *id.* at 474-476 & n.15. Finally, as the Court reaffirmed in *United States* v. *Naftalin, supra,* slip op. 6, the fact that this part of petitioner's fraudulent scheme was directed toward a business, rather than an investor, provides no immunity from prosecution, because 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).

C. Petitioner Defrauded Public Investors By Purchasing Securities From Them On The Basis Of Material Non-Public Information That He Converted From The Customers Of His Financial Printing Firm

Both courts below concluded that petitioner's purchase of securities based on material non-public information obtained by misappropriation constituted

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purchase stock options from the corporation without revealing material facts, violates the statute and the rule); *id.* at 865 (Friendly, J., concurring).

fraud on the sellers of those securities in violation of Section 10(b) and Rule 10b-5 (Pet. App. A2-A15, B3). Petitioner contends, however, that he did not commit fraud because he was subject to no duty to disclose or abstain from trading. He asserts that the duty to abstain from trading prior to public disclosure applies only to "insiders" of the corporations that have issued securities, "tippees" of such insiders, or persons having a "special trustee type of relationship" with other traders in the market (Br. 17, 19, 20, 22). Petitioner claims, in substance, the privilege of the ancient rule of *caveat emptor*. As we demonstrate below, petitioner's claim ignores established principles of the law of deceit, recognized both at common law and under the federal securities laws.

1. ***The rule of caveat emptor has never applied to transactions based on converted information that is inaccessible to other traders***

At common law, purchasers and sellers of goods were generally privileged to transact business with each other without disclosing their reasons for trading. See 2 T. Cooley, *Law of Torts* § 351, at 556 (4th ed. 1932): "*Caveat emptor* is the motto of commercial law, and in other dealings, as well as sales, every person is expected to look after his own interest, and is not at liberty to rely upon the other party to protect him against the consequences of his own blunders or heedlessness." [22] The rule of *caveat emptor* rewarded the astuteness of the informed trader and penalized

[22] See also II J. Kent, *Commentaries on American Law* 618-623 (7th ed. 1851); 12 *Williston on Contracts* §§ 1497-1499 (3d ed. 1970).

the heedlessness of the uninformed. Thus, "where the means of intelligence are equally accessible to both parties," a buyer was free at common law to purchase goods while in possession of material information bearing on the market for those goods, even if that information was unknown to the seller. *Laidlaw* v. *Organ*, 15 U.S. (2 Wheat.) 177, 195 (1817). Any other rule would penalize the "superior diligence and alertness" of the buyer, conduct that society should encourage rather than deter. See *id.* at 193.

But the purpose served by the rule of *caveat emptor* placed distinct limits on its scope. Thus, where (unlike in *Laidlaw*) the "means of intelligence" were not "equally accessible" to both traders, the common law decisions in certain commercial contexts imposed a duty of full disclosure. See, *e.g.*, 1 F. Harper & F. James, *The Law of Torts* § 7.14 at 588 (1956), describing the "salutary rule" requiring disclosure of facts "peculiarly and exclusively within the knowledge of one party to the transaction." [23] A duty of full disclosure applied at common law to those categories of commercial transactions in which one party had access to material information that was hidden from the other and good faith required candid dealing, as in

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[23] See also, *Carter* v. *Boehm*, 3 Burr. 1905, 1910 (1766) (Mansfield, J.); *Hanson* v. *Edgerly*, 29 N. H. 343, 358-359 (1856); *Rothmiller* v. *Stein*, 143 N.Y. 581, 595, 38 N.E. 718, 722 (1894); *Jones* v. *Arnold*, 359 Mo. 161, 169, 221 S.W.2d 187, 193 (1940); *Simmons* v. *Evans*, 185 Tenn. 282, 285-287, 206 S.W.2d 295, 296-297 (1947); *Jenkins* v. *McCormack*, 184 Kan. 842, 844, 339 P.2d 8, 11 (1959); *Lingsch* v. *Savage*, 213 Cal.App.2d 729, 735-738, 29 Cal. Rptr. 201, 204-206, (1963); Cf. *Stewart* v. *Wyoming Ranche Co.*, 128 U.S. 383, 388 (1888).

certain insurance contracts, contracts of sale, suretyship contracts, and compositions. See G. Bower, *The Law Relating To Actionable Non-Disclosure, supra*, at 58-110; *Kerr on Fraud and Mistake, supra*, at 87.

A duty to disclose information inaccessible to the seller received unequivocal recognition when the buyer misappropriated or otherwise improperly came into possession of the information that formed the basis for the transaction. See, *e.g.*, G. Bower & A. Turner, *The Law of Actionable Misrepresentation* 107 (1974): "In other words, suppression by a purchaser of facts affecting the value of the property which are not merely within his own knowledge, but the issue of his own volition and wrongful action, is equivalent to a misrepresentation." This principle is illustrated by the English case of *Phillips* v. *Homfray*, L.R. 6 Ch. 770, 779-780 (1871), where the buyers converted coal from the sellers' property prior to purchasing the property: "the case is not merely that the purchasers, being more experienced men, knew the value of the coal better than the vendors, but that the vendors being unable to gain access to the coal, the purchasers took advantage of an unlawful access to it in order to test its value * * *." The court added that the buyer must employ a "legitimate mode of acquiring knowledge" if the rule of *caveat emptor* is to apply. *Ibid.* See also Keeton, *Fraud—Concealment and Non-Disclosure*, 15 Tex. L. Rev. 1, 25-26 (1936):

> [T]he way in which the buyer acquires the information which he conceals from the vendor should be a material circumstance. The infor-

> mation might have been acquired as the result of his bringing to bear a superior knowledge, intelligence, skill or technical judgment; it might have been acquired by chance; or it might have been acquired by means of some tortious action on his part. * * * Any time information is acquired by an illegal act it would seem that there should be a duty to disclose that information, irrespective of the nature of the remedy.

See also *id.* at 35; accord, 1 F. Harper & F. James, *supra*, § 7.14 at 590.[24]

Thus, the common law rule of *caveat emptor* affords no immunity to petitioner. The policy served by the rule—encouragement of diligence by sellers and buyers—has no application to conversion of information to secure an advantage over uninformed traders. Even under a strict view of the rule of *caveat emptor*, the law of fraud imposed a duty to speak when one party to a transaction had information inaccessible to the other, and that information was obtained through lawless means.

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[24] The economic basis for this rule of law is discussed at length in Kronman, *Mistake, Disclosure, Information, And The Law of Contracts*, 7 J. Legal Stud. 1, 9 (1978). As Prof. Kronman explains, the cases applying the rule of *caveat emptor* arise in a context where the party charged with nondisclosure has acquired information through legitimate research or other bona fide economic activity. The law permits nondisclosure in such contexts to encourage socially desirable economic behavior. See also *id.* at 34. But where a trading advantage is the result of exclusive access to important information, obtained and used in violation of an explicit legal duty, the rule of *caveat emptor* has no logical application.

2. ***The federal securities laws were intended to replace the doctrine of caveat emptor with that of full disclosure and to forbid misuse of confidential business information for personal enrichment in the stock market***

If petitioner's claim of a right to trade without disclosure of misappropriated information finds little basis in common law precedent, it finds none under the federal securities laws. As this Court has repeatedly noted, "the 1934 Act and its companion legislative enactments embrace a 'fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*' * * *." *Affiliated Ute Citizens* v. *United States*, *supra*, 406 U.S. at 151 (footnote omitted); accord, *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963). Congress eliminated the rule of *caveat emptor* in securities transactions to restore investor confidence following the market crash of 1929.[25] Obtaining trading advantages over other investors through theft or

[25] See, *e.g.*, H.R. Rep. No. 1383, 73d Cong., 2d Sess. 5 (1934) ("If investor confidence is to come back to the benefit of exchanges and corporations alike, the law must advance. * * * Unless constant extension of the legal conception of a fiduciary relationship—a guarantee of 'straight shooting'—supports the constant extension of mutual confidence * * * easy liquidity of the resources in which wealth is invested is a danger * * *. Just in proportion as it becomes more liquid and complicated, an economic system must become more moderate, more honest, and more justifiably self-trusting"); S. Rep. No. 792, 73d Cong., 2d Sess. 3 (1934) ("The unfair methods of speculation employed by large operators and those possessing inside information regarding corporate affairs * * * have also been contributing causes of losses to investors").

conversion of confidential information is wholly inconsistent with the objectives Congress sought to achieve in 1934.[26] Those objectives were reaffirmed by Congress in 1975 when it amended the Securities Exchange Act of 1934, Pub. L. No. 94-29, 89 Stat. 97. See H.R. Conf. Rep. No. 94-229, 94th Cong. 1st Sess. 91-92 (1975):

> The basic goals of the Exchange Act remain salutatory and unchallenged: To provide fair and honest mechanisms for the pricing of securities, to assure that dealing in securities is fair and without undue preferences or advantages among investors * * * and to provide, to the maximum degree practicable, markets that are open and orderly.

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[26] See remarks of Rep. Wolverton, 78 Cong. Rec. 7865-7866 (1934) ("It is my hope and expectation that a wise and judicious administration of the provisions of this act will create a new confidence in the integrity of the security markets. * * * 'If there were a justifiable belief that security markets actually were "free and open", that all buyers and sellers met on substantially equal terms * * * the response would be a greater investment interest in securities and a consequent improvement in all phases of the security business.' "). Rep. Rayburn expressed similar views prior to the enactment of the Securities Act of 1933, 77 Cong. Rec. 2918 (1933) ("The purpose of this bill is to place the owners of securities on a parity, so far as is possible, with the management of the corporations, and to place the buyer on the same plane so far as available information is concerned, with the seller"). See also remarks of Rep. Rayburn, 78 Cong. Rec. 7697 (1934) ("We should have a market place for the exchange of securities, but it should be a clean and honest market place.").

In light of these statutory purposes, the Securities and Exchange Commission and the courts have repeatedly held that Section 10(b) and Rule 10b-5 prohibit corporate employees, officers and directors from taking personal advantage of material non-public information entrusted to them for business purposes. Such information must be made public before trading; if it cannot be made public, the possessor must abstain from trading. The analytic basis for this rule was summarized by the Commission in *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961) (emphasis supplied; footnote omitted):

> We have already noted that the anti-fraud provisions are phrased in terms of "any person" and that a special obligation has been traditionally required of corporate insiders, e.g., officers, directors and controlling stockholders. These three groups, however, do not exhaust the classes of persons upon whom there is such an obligation. *Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing that it is unavailable to those with whom he is dealing.*

The Commission's analysis parallels that of the common law decisions limiting the doctrine of *caveat emptor*: it is a sharp practice to reap profits by misappropriating non-public information and trading on the basis of that information with persons lacking access to it.

The rule of *Cady, Roberts* has received the sanction of every court that has considered it.[27] See, *e.g.*, *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969):

> [Section 10(b) and Rule 10b-5 are] based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information * * *. The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone"

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[27] The courts of appeals are unanimous in holding that trading on the basis of material inside information violates the statute and the rule. See *Kohler* v. *Kohler Co.*, 319 F.2d 634, 637-638 (7th Cir. 1963); *Myzel* v. *Fields*, 386 F.2d 718, 733-734 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); *Pennaluna & Co.* v. *SEC*, 410 F.2d 861, 869-870 (9th Cir. 1969), cert. denied, 396 U.S. 1007 (1970); *Stier* v. *Smith*, 473 F.2d 1205, 1208 (5th Cir. 1973). See also *Fridrich* v. *Bradford*, 542 F.2d 307, 318-322 & n.30, 323-327 & n.6 (6th Cir. 1976), emphasizing that criminal sanctions are available to enforce the prohibition. See generally III L. Loss, *Securities Regulation* 1445-1474 (2d ed. 1961); Schotland, *Unsafe At Any Price: A Reply To Manne, Insider Trading And The Stock Market,* 53 Va. L. Rev. 1425 (1967). The fact that other statutory provisions also extend to certain aspects of insider trading (see Section 16(b) of the Act, 15 U.S.C. 78p(b)) does not affect the coverage of Section 10(b). See *United States* v. *Naftalin, supra,* slip op. 9.

> may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," i.e., the investing public. * * * Insiders, as directors or management officers, are, of course, by this Rule, precluded from so unfairly dealing, but the Rule is also applicable to one possessing the information who may not be strictly termed an "insider" * * *.

This Court has also recognized that Section 10(b) and Rule 10b-5 forbid trading on the basis of material inside information. See *Foremost-McKesson, Inc.* v. *Provident Securities Co.*, 423 U.S. 232, 255 (1976), noting that "Congress has passed general antifraud statutes that proscribe fraudulent practices by insiders. * * * Today an investor who can show harm from the misuse of material inside information may have recourse, in particular, to § 10(b) and Rule 10b-5 * * *."

As both courts below recognized (Pet. App. A6-A8, B2-B3), there is no difference in principle between petitioner's conduct and that of an officer of an issuer corporation who trades on the basis of material non-public information.[28] Petitioner had access to confi-

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[28] Contrary to petitioner's assertion (Br. 22), none of the foregoing cases limit the principles that they announce to a special category of persons. For example, tippees, with no special relationship with the issuing corporation and no "inside" status, are forbidden to utilize non-public information. See *In re Investors Management Co.*, 44 S.E.C. 633, 643 (1971) ("We reject the contentions advanced by respondents that no violation can be found unless it is shown that the recipient himself occupied a special relationship with the issuer or insider corporate source giving him access to non-

dential commercial information of great importance to investors, who could not have learned of it through any exercise of diligent research. He misappropriated that information for personal enrichment, in violation of his duty as an agent.[29] The conduct of a corporate officer, director or other agent of an issuer corporation, who misappropriates confidential information and exploits uninformed investors, is functionally identical. Although the source of the information is different, the elements are the same: (1) critical information is available to only one party to the transaction and (2) that information is converted rather than acquired through research or other bona fide economic activity.[30] Nor is the impact on the

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public information * * *."). See also *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237-238 (2d Cir. 1974); *Kuehnert* v. *Texstar Corp.*, 412 F.2d 700, 702 (5th Cir. 1969). See generally A. Jacobs, *The Impact Of Rule 10b-5, supra*, § 66.02[a], at 3-273 to 3-278. As we discuss immediately below, these principles have been applied by the courts and the SEC in analogous cases involving market information frauds.

[29] Obtaining special trading advantages through misappropriation of confidential information is the very antithesis of obtaining a trading advantage through astute analysis of publicly available information, which the securities laws encourage. See *SEC* v. *Texas Gulf Sulphur Co., supra*, 401 F.2d at 848-849. See also *In re Investors Management Co., supra*, 44 S.E.C. at 641 n.18, distinguishing between information obtained by "general observation or analysis" and "industrial espionage."

[30] See *Diamond* v. *Oreamuno*, 24 N.Y.2d 494, 497-501, 248 N.E.2d 910, 912-914 (1969); *Brophy* v. *Cities Serv. Co.*, 31 Del. Ch. 241, 246, 70 A.2d 5, 8 (1949).

stock market different. As the court of appeals remarked (Pet. App. A15), "[i]t is difficult to imagine conduct less useful, or more destructive of public confidence in the integrity of our securities markets, than Chiarella's." [31] In short, the courts below correctly concluded that the mandate to "disclose or abstain" applied to petitioner. His trading on the basis of misappropriated information is a classic example of the kind of "deceptive practice[]" that can "fullfill no useful function." *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 206.[32]

3. *The fact that petitioner misappropriated non-public market information, rather than inside corporate information, does not immunize his conduct*

a. *Section 10(b) and Rule 10b-5 apply to petitioner's scheme even though the precise factual pattern involved here has not been presented in prior litigated cases*

Petitioner argues (Br. 20, 22) that the principles described above have no application to him because he was not an "insider" or a "tippee" of an insider,

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[31] If, as petitioner suggests, the securities laws are not available to restrain or punish conduct such as his own, then other members of tender offer team might be encouraged to exploit material non-public information for personal gain. These persons include lawyers, accountants, bankers, corporate employees and secretaries. Highly profitable trading on the basis of such undisclosed information would scarcely be an isolated occurrence.

[32] Petitioner was, of course, forbidden to disclose the confidential information here in question. It was therefore incumbent upon him to await disclosure by the acquiring companies before commencing to trade for his own account. See *SEC* v. *Texas Gulf Sulphur Co., supra,* 401 F. 2d at 848.

as described in *Cady, Roberts* and *Texas Gulf Sulphur.* But such a limiting interpretation cannot be squared with the literal text of Section 10(b), which applies to "any" fraudulent scheme, or with the legislative history of the statute, which shows that it was intended to be a "catchall" extending to all "new cunning devices." See pages 25-28, *supra.* As this Court noted in *Superintendent of Insurance* v. *Bankers Life & Casualty Co., supra,* 404 U.S. at 11 n.7 (quoting *A. T. Brod & Co.* v. *Perlow,* 375 F.2d 393, 397 (2d Cir. 1967) (emphasis in original)):

> "We believe that § 10(b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws."

Similarly, in *United States* v. *Naftalin, supra,* slip op. 3, this Court rejected the argument that the general antifraud provision in Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), should be limited to frauds of the kind involved in prior litigated cases—*i.e.,* frauds aimed at investors. The Court noted that "[n]othing on the face of the statute supports this reading of it" (slip op. 3).[33]

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[33] Naftalin unsuccessfully argued in this Court that Section 17(a) should be limited to "investor" frauds in conformity with prior litigated cases: "in the entire history of Section 17(a) of the 1933 Act there existed 'no case in which [the statute] has been used to prosecute a defendant for fraud in the sale of securities perpetrated upon an agent-broker * * *'" (Br. 32).

In rejecting Naftalin's argument, the Court cited *United States* v. *Brown*, 555 F.2d 336 (2d Cir. 1977) (see slip op. 6), which held:

> The 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.

Id. at 339-340. Nothing in Section 10(b) or Rule 10b-5 suggests that its prohibitions are confined to "insiders," "tippees" of insiders or "inside information." Frauds involving market information,[34] like any other frauds practiced in connection with a purchase or sale of securities, fall within the coverage of these broad antifraud provisions.[35]

Nor do economic considerations support petitioner's arguments about the scope of Section 10(b) and Rule 10b-5. The profits to be made from market information fraud, and the unfairness to investors, are at least as great as in inside information cases. Market information concerning forthcoming tender offers or acquisitions has tremendous importance to investors,

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[34] In this brief, the term "market information" refers to information about the demand in the market for a particular security, as opposed to the value of the assets or earning power of the corporation that issues the security. See Pet. App. A8 n.8.

[35] Moreover, as we demonstrate on pages 56-61, *infra*, prior decisions of this Court and the lower federal courts have applied the "disclose or abstain" principle in market information cases that are analogous to the present case.

particularly in a period of increased tender offer activity. The price of a security at any given time depends on two things: the earning power and assets of the issuing corporation and the market demand for the security. The market may capitalize corporate earnings and assets at different levels, depending upon investor demand. Demand for securities reaches its apex during a tender offer, when the offeror agrees to pay a "premium" above the current market price. That premium can be quite substantial. A recent survey of tender offers occurring in 1975 and 1976 showed that the premium over the previous closing price for target company shares ranged from 22% to 66%. See Troubh, *supra*, 54 Harv. Bus. Rev. at 82.[36] Foreknowledge of a tender offer is *certain* knowledge that the shares owned by the seller are worth substantially more than he believes. Obtaining such knowledge by theft or other dishonest means in order to exploit a seller who is in ignorance of an impending tender offer is an act of deception and dishonesty properly forbidden by Section 10(b) and Rule 10b-5.

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[36] See also Statistical Spotlight, *Forbes*, Feb. 9, 1979 at 69 (analysis of 40 largest takeovers in 1978 showed premiums of 40% or more to be common, with premiums of over 100% in some cases). As noted in Borden & Weiner, *An Investment Decision Analysis of Cash Tender Offer Disclosure*, 23 N.Y. L.Sch. L. Rev. 553, 575-576 (1978), from the point of view of the offeree, "price is * * * the name of the game." Where there is a reasonable premium, "investors almost always sell."

b. *The statutory context shows that Section 10(b) applies to all frauds, including market information frauds*

The structure of the Securities Exchange Act of 1934 supports the view that Section 10(b) should extend to all fraudulent schemes, including those involving market information. Section 10(b) stands between Sections 9 and 11 of the Act; the three provisions may be viewed *in pari materia.* See VI Loss, *supra,* at 3528. See also *SEC* v. *National Securities, Inc.,* 393 U.S. 453, 466 (1969) ("the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen * * *").

Section 11(b) of the Act, 15 U.S.C. 78k(b), places strict limitations on securities exchange specialists who possess non-public market information. Those limitations prevent tipping of market information and discretionary trading for customers on the basis of such information:

> It shall be unlawful for a specialist or an official of the exchange to disclose information in regard to orders placed with such specialist which is not available to all members of the exchange, to any person other than an official of the exchange, a representative of the Commission, or a specialist who may be acting for such specialist * * *. It shall also be unlawful for a specialist permitted to act as a broker and dealer to effect on the exchange as broker any transaction except upon a market or limited price order.

The specialist's market-making role necessitates his own purchases and sales of securities to promote continuous and orderly price movements. But Congress prohibited misuse of the market information entrusted to him: "The specialist is forbidden to reveal the orders on his books to favored persons. This information must be available to all members or else kept entirely confidential. The specialist is likewise prohibited from exercising purely discretionary orders as distinct from market or limited price orders." S. Rep. No. 792, 73d Cong., 2d Sess. 18 (1934); H.R. Rep. No. 1383, 73d Cong., 2d Sess. 22 (1934). See also S. Rep. No. 1455, 73d Cong., 2d Sess. 25-30 (1934). During debates on Section 11(b), Congress focused on the unfairness inherent in permitting certain traders to utilize non-public market information for personal gain:

> [I]s there not a danger that a few men on the inside, the officers of the exchange, may secure from the specialist in advance any and all information they desire, precisely as they have heretofore?
>
> Will they not still be able to obtain information that will apprise them in advance of all the other members of the exchange knowledge of the accumulated overnight orders to buy or sell various stocks, the amount and the prices at which the sellers will sell, and the prices at which buyers are willing to buy? * * * Armed with this confidential information, they would be able easily to decide what course to pursue as between buying or selling. Or, in other words, * * * they

> would have the opportunity of looking into all the other players' hands, and then of making their bets at this gambling table in safety not only to the disadvantage of outside investors but even to the [dis]advantage of their fellow members of the gambling fraternity as well. It is practically the same as if they were playing with marked cards.

78 Cong. Rec. 8031-8032 (1934) (remarks of Rep. Sabath). These concerns led to the adoption of the restrictions on specialist activities contained in Section 11(b).

Like Section 11(b), Section 9(a)(1) of the Act, 15 U.S.C. 78i(a)(1), seeks to prevent market information frauds. That provision prohibits, *inter alia*, manipulative securities transactions that have

> * * * the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange, or a false or misleading appearance with respect to the market for any such security * * *.

Market manipulation, in the view of Congress, effectively defrauds public investors by misleading them about current market facts. See S. Rep. No. 1455, 73d Cong., 2d Sess. 32 (1934) ("In all cases fictitious activity is intentionally created, and the purchaser is deceived by an appearance of genuine demand for the security"); H.R. Rep. No. 1383, 73d Cong., 2d Sess. 10 (1934).

Viewing Section 10(b) in this statutory context thus fortifies the conclusion that it applies to all fraudulent schemes, including those involving market information. Congress recognized the danger to investors from market information frauds and attempted to minimize that danger in Sections 9 and 11 of the Act. Section 10(b), the catchall provision inserted between Sections 9 and 11 to deal with any new cunning devices, should be construed in accordance with that recognition. In the view of Congress, misuse of market information is a deceptive device or contrivance—in the words of Representative Sabath, it is the same as "playing with marked cards."

c. *This Court and the lower federal courts have applied Section 10(b) and Rule 10b-5 to market information frauds*

This Court's decision in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 144-154 (1972), confirms that Section 10(b) and Rule 10b-5 can apply to trading by persons, not insiders or tippees of insiders, possessing material non-public market information. The defendants in *Ute* purchased shares in their individual capacities directly from the plaintiffs and arranged for the sale of shares to third parties, effectively serving as market makers in the securities in question. They failed to disclose to the sellers at the time of purchase that the current market value of the stock on the resale market was far higher than the sellers believed. The Court held that this failure to disclose market information constituted a violation of the statute and the rule, noting that "[t]he sellers had the right to know that the defendants were in a position to gain financially from their sales and that their shares were selling for a higher price in that market." 406 U.S. at 153.[37]

Petitioner's situation is the same as that of the defendants in *Ute*. He purchased securities while in possession of unquestionably material market information that was unknown, and could not have been known, to the sellers. Although the defendants in *Ute* had a special relationship with the sellers by virtue of their market-making role, petitioner's position imposed on him similar if not more exacting responsibilities. His professional duties placed him near the center of major market-shaping events. It was his job to maintain the confidentiality of critically important information that would create substantial preferences and unfairness in the marketplace if leaked or selectively revealed. It was also his job to help prepare documents that he knew were to be publicly disclosed to all investors on an equal basis. As the court of appeals observed, a "financial print-[er] * * * [is] a central, though generally unheralded, cog in the vital machinery for disseminating infor-

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[37] The Court rejected the defendants' contention that they could not be guilty of fraud because they merely stood "mute": "We do not read Rule 10b-5 so restrictively. To be sure, the second subparagraph of the rule specifies the making of an untrue statement of a material fact and the omission to state a material fact. The first and third subparagraphs are not so restricted. These defendants' activities * * * disclose, within the very language of one or the other of these subparagraphs, a 'course of business' or a 'device, scheme or artifice' that operated as a fraud upon the Indian sellers." 406 U.S. at 152-153. Accord, *SEC* v. *Capital Gains Research Bureau, Inc., supra,* 375 U.S. at 197-198.

mation to investors" (Pet. App. A7). Petitioner perverted that function by misappropriating the information entrusted to him and exploiting uninformed investors. Since, as *Ute* emphasizes, the securities laws were intended to preserve "a high standard of business ethics" in all aspects of the securities industry (406 U.S. at 151), petitioner may not contend that his role in the securities market was any less "special" or required less "trust" than that of the defendants in *Ute*.[38]

The lower courts have also held that fraudulent practices involving market information violate Section 10(b) and Rule 10b-5. The facts in *SEC* v. *Shapiro*, 494 F.2d 1301, 1303-1307 (2d Cir. 1974), for example, bear a striking resemblance to those presented here. The defendants in *Shapiro* were consultants who assisted an acquiring company in its efforts to merge with a target company. Aware of the impending merger, the consultants purchased shares in the target company for themselves, selling them at a large profit after public announcement of the merger

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[38] Petitioner also argues (Br. 33) that *Ute* is inapplicable here because it recognized that "transfer agents" would not ordinarily be required to make disclosure to investors. But transfer agents normally do not purchase securities; they merely record transfers of securities on the books of issuer corporations. Unlike a transfer agent, petitioner purchased large quantities of securities for himself at a substantial personal profit (see Pet. App. A4 n.3). And, in contrast to an ordinary transfer agent, petitioner was entrusted with highly confidential information, which he misused in violation of the rules of his employer and in breach of his duty to his employer's customers.

plan. The court of appeals concluded that this misuse of material non-public information for personal enrichment violated the statute and the rule.[39] In sum, the application of Section 10(b) and Rule 10b-5 to market information frauds has substantial judicial precedent; it is the materiality of the nonpublic information, not its source, that is relevant under the statute and the rule.

d. *The Securities and Exchange Commission has applied Section 10(b) and Rule 10b-5 to various kinds of market information frauds*

For over 30 years, the Securities and Exchange Commission has brought enforcement proceedings in cases involving market information frauds. See, *e.g.*, *In re Herbert L. Honohan*, 13 S.E.C. 754 (1943) (misappropriation of information about sealed bids to learn market facts inaccessible to other persons); *In re Blyth & Co.*, [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,647 (1969) (use of material non-public information about interest rates affecting market conditions wrongfully ob-

[39] See also *Zweig* v. *Hearst Corporation*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,851, at 95,460-95,462 (9th Cir. 1979) (market information fraud by financial columnist); *Courtland* v. *Walston & Co.*, 340 F. Supp. 1076, 1082-1084 (S.D. N.Y. 1972) (market information fraud by broker). See generally Jacobs, *The Impact of Rule 10b-5*, *supra*, § 66.02[b], at 3-289 to 3-292. These decisions support the proposition announced by the Second Circuit over 30 years ago: "The essential objective of securities legislation is to protect those who do not know market conditions from the over-reachings of those who do." *Charles Hughes & Co.* v. *SEC*, 139 F.2d 434, 437 (2d Cir. 1943), cert. denied, 321 U.S. 786 (1944).

tained from a Treasury Department employee). See also *SEC* v. *Hancock*, SEC Litigation Release No. 505 (Mar. 18, 1949), condemning a scheme to misappropriate information for personal trading advantages. In *Hancock*, an employee of an investment company relayed information about planned securities purchases by the company to a broker, who purchased the shares cheaply and subsequently resold them to the company at a profit. This scheme to defraud, involving market information, was the basis for a subsequent criminal indictment. See *United States* v. *Hancock*, SEC Litigation Release No. 530 (Aug. 8, 1949).

The Commission has also brought a number of enforcement proceedings under Section 10(b) and Rule 10b-5 when confidential market information concerning forthcoming corporate acquisitions is misappropriated and used in the public securities markets. See, *e.g.*, the consent decrees in *SEC* v. *Sorg Printing Co.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,767 (S.D.N.Y. 1974); *SEC* v. *Primar Typographers, Inc.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,734 (S.D.N.Y. 1976); *SEC* v. *Ayoub*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,567 (S.D.N.Y. 1976); *SEC* v. *Manderano*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,357 (D.N.J. 1978). Enforcement actions have also been commenced against executives of acquiring companies who purchased shares of target company stock prior to public revelation of a tender offer. See, *e.g.*, *SEC* v. *Rosenberg*, [1974-1975

Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,766 (S.D.N.Y. 1974); *SEC* v. *Healy*, SEC Litigation Release No. 6589 (S.D.N.Y. 1974); *SEC* v. *Stone*, SEC Litigation Release No. 8527 (S.D.N.Y. 1978). See also *FTC* v. *Mandel Brothers, Inc.*, 359 U.S. 385, 391 (1959) (administrative interpretation entitled to deference "even though it was applied in cases settled by consent").

Thus, application of Section 10(b) and Rule 10b-5 to market information frauds finds substantial support in the enforcement actions of the administrative agency vested with primary responsibility for interpreting the Securities Exchange Act of 1934.

e. *Petitioner's proposed limitation of the statute and the rule would lead to absurd results*

The limiting interpretation of Section 10(b) and Rule 10b-5 that petitioner urges would result in illogical legal standards. The essence of petitioner's claim is that persons such as himself who have no relationship with the issuing corporation and who obtain non-public information solely from the acquiring corporation may freely use that information in the stock market. This is so, petitioner argues, because they do not obtain their information from traditional inside sources and have no express fiduciary relationship with the issuing corporation or other traders in the market (Br. 19, 20, 22).

If petitioner's contention were adopted, it would mean that an officer or director of a tender offeror could purchase large quantities of target company stock for his own account after emerging from a meeting at which plans to make a tender offer had been approved. However, if, instead of a tender offer, the acquisition was a negotiated corporate merger, and the same acquiring company officer or director learned of the acquisition from attending a confidential meeting also attended by the target company's officers, his information would be "inside." His source would be the "issuer corporation" and, under petitioner's analysis, the employee would be forbidden to purchase shares in the target company.[40] Despite the fact that confidential corporate information is misappropriated in both cases for the purpose of exploiting uninformed investors, petitioner's proposed rule of law would impose liability in one instance but not the other.

The same anomaly would arise in the case of printers. Under petitioner's proposed rule, printers who convert non-public information from tender offerors may freely purchase securities in the target company at the expense of uninformed investors. But if a printer obtains his information by reviewing confidential merger documents submitted by the target company rather than the acquiring company, then, under petitioner's theory, he is forbidden to trade.

These examples expose the arbitrariness of petitioner's proposed legal standard. Indeed, the only

[40] As petitioners' argument recognizes, when confidential market information concerning a forthcoming acquisition stems from the issuer corporation, Section 10(b) and Rule 10b-5 clearly prohibit tipping and use of that information for personal trading. See, *e.g.*, *SEC* v. *Geon Industries, Inc.*, 531 F.2d 39 (2d Cir. 1976).

discernible logic of petitioner's standard is that it excludes *him* from liability. Under the established principles of fraud that we have discussed above, each of the traders in the preceding examples has violated Section 10(b) and Rule 10b-5. Each has misappropriated confidential corporate information in violation of his duty as an agent and each has used that information to exploit uninformed investors in the purchase or sale of securities. As the court of appeals recognized (Pet. App. A13-A15), conversion of confidential information for the purpose of obtaining an advantage over other investors undermines public confidence in the national securities markets and conflicts with the congressional purpose to eliminate all frauds in securities transactions. This is true regardless of the formal relationship between the buyer and seller or the source of the non-public information that is used for personal enrichment at the expense of other traders.

4. *Petitioner's conversion of market information for the purpose of exploiting uninformed investors bears no resemblance to the actions of business firms engaged in bona fide economic activity*

Petitioner contends (Br. 25-29) that his conduct is "identical" to that of tender offerors who, prior to publicly announcing their acquisition plans, may purchase up to 5% of the stock of target companies on the open market.[41] He also argues that if he is subject

[41] Under the Williams Act amendments to the Securities Exchange Act, 15 U.S.C. 78m(d), 78n(d), an acquiring firm, including a tender offeror, must disclose various facts about itself and its acquisition plans after it acquires 5% of any

to liability, then bona fide activities of businesses such as "specialists," "block positioners," and "arbitrageurs" likewise "would be subject to Rule 10b-5 liability" (Br. 34). The court below correctly concluded (Pet. App. A10-A15) that there is no substance to these comparisons and no reason to extrapolate rules of liability appropriate in this case to other situations presenting different questions of fact and public policy.

The facts in this case do not show simple possession of non-public market information generated by bona fide economic activity. As the court of appeals noted, the undisputed evidence at trial proved that petitioner "converted" information from the customers of Pandick Press for personal enrichment in the stock market (Pet. App. A13); the district court described his conduct as a form of "embezzlement" (*id.* at B2). The common law of fraud, as we have discussed on pages 39-42, *supra*, drew a clear distinction between use of information obtained by misappropriation and bona fide economic activity. See Keeton, *supra*, 15 Tex. L. Rev. at 25-26, 35; Bower & Turner, *supra*, at 107; Kronman, *supra*, at 9, 13-18, 33-34. By the same token the antifraud provisions of the federal securities laws are aimed at " 'manipulative and deceptive practices which . . . fulfill no useful function' " (*Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S.

class of stock of the issuer. As originally enacted, these provisions required disclosure when 10% of the target company's stock had been acquired; the figure was lowered to 5% in 1970.

at 206), not at bona fide business activity.[42] In these circumstances, there is no basis for the assertion that petitioner's conduct should be immunized under legal principles that have been applied to legitimate forms of commercial activity or that affirmance of the decision below would cast doubt on the propriety of those activities.

Petitioner's contention that his conversion of confidential information for personal trading is "identical" with the actions of tender offerors totally ignores the nature of the commercial operations in which tender offerors engage and the regulatory framework that surrounds them. Tender offerors participate in bona fide economic activity within a pervasive scheme of regulation that accommodates their legitimate interests with those of the investing public.

To protect the interests of both investors and tender offerors, the Williams Act does not require the filing of disclosure documents until a tender offer is "first published, or sent or given to security holders." 15 U.S.C. 78n(d)(1). Prior to the commencement of the tender offer, disclosure is not required unless the acquiring company obtains 5% of any class of the

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[42] Congress intended the securities laws to protect the investing public with the least interference to honest business. See, *e.g.*, remarks of Rep. Wolverton, 78 Cong. Rec. 7863 (1934) ("The uppermost thought that has dominated our individual and collective decisions has been a desire to correct existing evils, or conditions that have proved harmful, without destroying, curtailing, or handicapping legitimate business."). Accord, remarks of Rep. Chapman, *id.* at 7925; remarks of Rep. Rayburn, *id.* at 8013.

target company's securities. See 15 U.S.C. 78m(d)(1). Thus, premature disclosure, which could frustrate market-testing by a potential tender offeror, is not compelled. This reflects a careful congressional balancing. As Senator Williams stated prior to enactment of the Williams Act: "I have taken extreme care with this legislation to balance the scales equally to protect the legitimate interests of the corporation, management, and shareholders without unduly impeding cash takeover bids." 113 Cong. Rec. 854 (1967). See also S. Rep. No. 550, 90th Cong., 1st Sess. 3 (1967); *Rondeau* v. *Mosinee Paper Corp.*, 422 U.S. 49, 58-59 (1975).[43]

This congressional balancing of interests has no application to petitioner's case, as the courts below correctly held.[44] Congress has expressed no policy

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[43] Senator Williams also pointed out: "Substantial open market or privately negotiated purchases of shares may precede or accompany a tender offer or may otherwise relate to shifts in control of which investors should be aware. While some people might say that this information should be filed before the securities are acquired, disclosure after the transaction avoids upsetting the free and open auction market where buyer and seller normally do not disclose the extent of their interest * * *." 113 Cong. Rec. 856 (1967). As this indicates, there is normally no requirement that a person advise the market of the amount of stock he is planning to buy or sell. But where investment decisions are based on information concerning forthcoming tender offers that is converted or embezzled, entirely different considerations are presented.

[44] The SEC has recently proposed a rule (SEC Rule 14e-2(c)) under the Williams Act that would bar trading by the tender offeror in the target company's securities once it "has

judgment in favor of his dishonest scheme. Petitioner engaged in no bona fide economic activity that justifies trading prior to public disclosure. Unlike a tender offeror, which ordinarily undertakes an acquisition program based on independent analysis and economic planning and which assumes the risks of the investment process, petitioner converted information not publicly available and used that information to bet on a sure thing. Unlike tender offerors, who must disclose their plans and actions at the time prescribed by Congress under the Williams Act, petitioner did not make any disclosure to anyone. And unlike the activities of tender offerors which can promote investor welfare (see *Rondeau* v. *Mosinee Paper Corp.*, *supra*, 422 U.S. at 58 n.8), petitioner's actions served

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determined to make a tender offer," unless public disclosure of its intentions is made. The proposed rule would afford additional protection to public investors. This proposal is based on the premise that the tender offeror should be permitted to "test the market" only so long as it is still undecided about whether to make an offer. Proposed Rule 14e-2(a) would also specify that persons other than the tender offeror (including persons such as "warehousers") may not trade on the basis of confidential information concerning the offer. See 44 Fed. Reg. 9956, 9976-9978 (1979). Proposal of these specific rules does not imply that the conduct they cover was previously immune from regulation under other, more general, statutory provisions or rules or that fraud occurring in the course of that conduct would not violate Section 10(b) and Rule 10b-5 if practiced in connection with a securities purchase or sale. See generally *SEC* v. *National Securities, Inc.*, *supra*, 393 U.S. at 468; *United States* v. *Naftalin*, *supra*, slip op. 9; see also *Electronic Specialty Co.* v. *International Controls Corp.*, 409 F.2d 937, 940-941 (2d Cir. 1969).

only to injure other investors and the tender offerors whose confidence he betrayed.

General Time Corp. v. *Talley Industries, Inc.*, 403 F.2d 159, 164-165 (2d Cir. 1968), relied on by petitioner, offers no support to his position. *General Time* held that an acquiring company need not disclose its acquisition plans prior to making certain open market purchases. The court observed that, at least in the initial stages of the acquisition, requiring the purchaser to make a public announcement of his plans could easily result in anticipatory price increases and thus "abort" the acquisition. Nothing in *General Time* suggests that persons who trade on the basis of information converted from acquiring companies have a privilege to enrich themselves. The court's concern for the effectiveness of the tender offer and the need to preserve pre-announcement secrecy confirm that its reasoning would not condone a scheme of the kind involved here, which had the clear potential to frustrate bona fide tender offers (see Pet. App. A13; see also pages 34-35, *supra*).[45]

The case of the specialist is similar to that of the tender offeror. As noted on pages 53-55, *supra*, Congress recognized that specialists who make a market in securities while in possession of information about prevailing public demand for those securities con-

[45] See A. Jacobs, *supra*, § 66.02[b], at 3-284 (footnote omitted), noting that the rule in *General Time* has no application to persons in petitioner's position: "[T]his [rule] cannot justify purchases by persons who know the tenderor's plans. Trading by persons having this informational inequity is contrary to the Rule's policies."

tribute to the stability of prices on the national securities exchanges. The Act expressly authorizes the registration of specialists to serve as market makers. See Section 11(b) of the Act, 15 U.S.C. 78k(b). As discussed above (see page 54, *supra*), Section 11(b) balances the legitimate interests of the specialist and the investing public. Specialists are prohibited from selectively tipping other traders or placing discretionary orders for preferred customers on the basis of non-public market information contained in their books. Due to their essential role in the market, however, they are not altogether forbidden to trade while in possession of market information.[46]

The fact that businesses may ordinarily engage in specialist activities, open market purchases, arbitrage or block trading (within statutory and regulatory restrictions) without disclosing information generated by *their own* activities does not immunize petitioner's conduct. Unlike these businesses and

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[46] Other participants in the securities markets, such as block traders, arbitrageurs, bank trust departments, mutual funds, and insurance companies, also may possess information about impending changes in market conditions due to their ability to buy and sell large quantities of stock. Congress recognized that large transactions by such institutions may have some impact on market price, but it acknowledged that such transactions are a necessary part of the operation of the national securities markets. See H.R. Rep. No. 1383, 73d Cong., 2d Sess. 20 (1934); S. Rep. No. 792, 73d Cong., 2d Sess. 17 (1934). See also Section 11(a)(1)(A)-(D) of the Act, 15 U.S.C. 78k(a)(1)(A)-(D).

ordinary investors participating in the nation's securities market, petitioner converted confidential market information of another person intended for a special commercial purpose.[47] As explained in the brief *amicus curiae* of the Securities Industry Association (page 30),[48] there is no reason why imposition of

[47] Petitioner's conversion of confidential information to secure an advantage over uninformed traders in the public securities markets is totally unlike the bona fide research activities of investors, brokers and stock market analysts who achieve superior insights through investigation of publicly available information. See note 29, *supra*.

[48] We agree with the contention of the brief *amicus curiae* that certain language in the opinion of the court of appeals, taken out of context, incorrectly suggests that mere possession or regular receipt of confidential market information precludes market professionals (such as market makers, specialists, arbitrageurs, and block traders) from carrying on their normal business activities. Each of these businesses purchases and sells securities as a necessary part of its operations and possesses from time to time confidential information about market conditions that is generated by its own bona fide commercial activity. We do not understand the opinion of the court of appeals, viewed in its entirety, to question the propriety of these business operations. Significantly, the court was careful to point out: "We are not to be understood as holding that no one may trade on nonpublic market information without incurring a duty to disclose" (Pet. App. A10). In this connection, the court referred to the case of tender offerors, which may possess market information generated by their own legitimate activities. Thus, while we agree with the court of appeals that Section 10(b) and Rule 10b-5 apply to theft or misappropriation of confidential information for personal use in the stock market by both traditional corporate insiders and market insiders such as petitioner, we also agree with *amicus* that Section 10(b) and Rule 10b-5 would not ordinarily prohibit market professionals from

liability on agents who fraudently misappropriate confidential information for personal enrichment should establish a precedent applicable in areas of legitimate business activity.[49]

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carrying on their securities business while in possession of confidential information stemming from their own legitimate business operations. That is not to say, however, that the activities of such professionals may never violate the statute and the rule. If, for example, a block trader, arbitrageur, or portfolio manager received a tip from a printer and realized that he was obtaining converted information about an impending tender offer, subsequent trading on the basis of that information would violate Section 10(b) and Rule 10b-5.

We do not agree with the assertion of *amicus* that the SEC is required to proceed by rule-making in developing standards to govern the use of market information by securities industry professionals. To be sure, detailed rules may prove to be workable in some areas. But as Professor Loss has pointed out, an appropriate standard of conduct applicable in different contexts does not readily "lend itself to definition." ALI, *Federal Securities Code* § 1603, at 538-539 (Proposed Official Draft 1978). Professor Loss notes that new and "egregious" forms of fraud involving market information are properly dealt with under general antifraud provisions, adding that "this area must be left to further judicial development." *Ibid.* Particularized rules for different commercial contexts are, of course, desirable when feasible, but the decision whether to proceed by rule-making or adjudication remains a question committed to administrative discretion. *SEC* v. *Chenery Corp.*, 332 U.S. 194, 201-203 (1947); *NLRB* v. *Bell Aerospace Co.*, 416 U.S. 267, 290-295 (1974). In any event, that question is not presented in this case.

[49] The brief *amicus curiae* correctly notes (Br. 30) that "liability under Rule 10b-5 may be predicated upon the deliberate, and purely personal, utilization of market information, where the information was received solely by virtue of a confidential business relationship, and where there is a clear

In summary, this case involves only the narrow question whether Section 10(b) and Rule 10b-5 prohibit the unlawful conversion and use of market information not available to the general public in an effort to exploit uninformed investors. Petitioner's trading on undisclosed information cannot be analogized to bona fide commercial activity. As the court of appeals concluded, the law properly distinguishes between petitioner's conduct and that of the tender offerors, specialists, and block traders to whom he would compare himself.

II. SECTION 10(b) AND RULE 10b-5 AND THEIR RELEVANT INTERPRETATIONS PROVIDED FAIR NOTICE THAT PETITIONER'S CONDUCT WAS UNLAWFUL

Petitioner contends (Br. 38-48), that he was denied "fair notice" that his conduct violated Section 10(b) and Rule 10b-5. He argues that the legal basis for his prosecution was so obscure that, even had he consulted an attorney, he would not have learned that his actions entailed a substantial risk of criminal liability (Br. 38, 41, 48).

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showing 'that an expectation of fair dealing . . . is justified.'" See also Fleischer, Mundheim & Murphy, *An Initial Inquiry Into The Responsibility To Disclose Market Information*, 121 U. Pa. L. Rev. 798, 822 (1973): "[I]t may be realistic to expect that a market professional who is given a preferred position in order to fulfill a particular market function will use any confidential information received as a consequence of his position solely to further his assigned role." Accord, Comment, *The Application of Rule 10b-5 to "Market Insiders": United States* v. *Chiarella*, 92 Harv. L. Rev. 1538, 1547 (1979).

1. Petitioner's argument ignores the fact that the statute and rule prohibit all fraudulent schemes. They provide the clearest possible warning that any deceptive device or contrivance, scheme or artifice to defraud, or course of business that operates or would operate as a fraud on any person is unlawful.[50] The scope of these provisions is unequivocal: every scheme to defraud is forbidden if practiced in connection with a purchase or sale of securities and through use of the prescribed jurisdictional means.

Prior to petitioner's actions, this Court had confirmed that Section 10(b) and Rule 10b-5 prohibit fraudulent misappropriations practiced in connection with securities transactions (*Superintendent of Insurance* v. *Bankers Life & Casualty Co., supra*); the lower courts had uniformly held that trading on the basis of inside corporate information was illegal (*SEC* v. *Texas Gulf Sulphur Co., supra*); and this Court had held that failure to disclose market information could constitute a fraud under the statute (*Affiliated Ute Citizens* v. *United States, supra*). Before petitioner acted, the Second Circuit also held that persons aware of corporate acquisition plans

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[50] See *Speed* v. *Transamerica Corp.*, 99 F. Supp. 808, 832 (D. Del. 1951):

> In enacting the section, Congress sought to eliminate, within the sphere of federal jurisdiction, all deceptive devices or contrivances. * * * As stated by Judge Cardozo [in *People* v. *Mancuso*, 255 N.Y. 463] "one is at a loss to imagine how" this broad objective "could be more accurately stated, without a catalogue of particulars not susceptible of enumeration in advance of the event."

could not purchase shares in the target company prior to public disclosure (*SEC* v. *Shapiro*, *supra*). Moreover, the Securities and Exchange Commission had commenced judicial and administrative proceedings based on market information frauds and had filed complaints against printers under Section 10(b) and Rule 10b-5 when they traded on the basis of non-public tender offer news. See pages 59-61, *supra*. Thus, the agency charged with the interpretation and enforcement of the Act had expressed its view that petitioner's conduct could give rise to a violation (*SEC* v. *Sorg Printing Co.*, *supra*).[51]

The Securities Exchange Act of 1934 expressly authorizes criminal prosecutions for willful violations of its provisions and the rules promulgated thereunder. See 15 U.S.C. 78ff.[52] Before petitioner undertook his scheme to defraud, numerous criminal prosecutions had been commenced by the Department of

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[51] Of course, petitioner was also on warning that the statute and rule would receive a broad and flexible interpretation. See *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, *supra*, 404 U.S. at 12; 1 Bromberg, *supra*, at § 2.2(332).

[52] This case involves a prosecution under a statute defining a specific federal offense. Although, as the dissenting judge noted in the court below (Pet. App. A33), this Court's recent decisions have restricted the availability of "implied remedies," the Court has not hesitated to give full scope to criminal enforcement proceedings expressly authorized by Congress. *United States* v. *Naftalin*, *supra*. Limitation of implied private remedies, which serve as supplements to government enforcement proceedings, gives added importance to the efforts of the Department of Justice and the Securities and Exchange Commission to obtain compliance with the statute.

Justice under Section 10(b) and Rule 10b-5 where willful violations were found to exist, including, as noted on page 60, *supra*, a case involving a market information fraud.[53]

If petitioner or an attorney consulted by him had made even a minimal effort to ascertain the requirements of the law, they would have learned that petitioner's intended conduct entailed a substantial risk of criminal liability. "No honest and reasonable citizen could have difficulty in understanding" the illegality of that course of conduct. See *United States* v. *Persky*, 520 F.2d 283, 286-288 (2d Cir. 1975), rejecting a similar "fair notice" claim under Section 10(b) and Rule 10b-5. The argument that no "omens" or "portents" of liability were present (Br. 41) ignores the broad prohibitory language of the statute and rule and the line of authority that we have summarized above. Simply stated, a person of ordinary intelligence had fair notice that the decep-

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[53] See, *e.g.*, *United States* v. *Re*, 336 F.2d 306 (2d Cir.), cert. denied, 379 U.S. 904 (1964) (market manipulation); *United States* v. *D'Honau*, 459 F.2d 73 (9th Cir. 1972) (market manipulation); *United States* v. *Koss*, 506 F.2d 1103 (2d Cir. 1974) (failure to deposit proceeds of offering); *United States* v. *Persky*, 520 F.2d 283 (2d Cir. 1975) (false press releases); *United States* v. *Wolfson*, 289 F. Supp. 903 (S.D. N.Y. 1968) (fraudulent distribution of securities). Many other criminal indictments under Section 10(b) and Rule 10b-5 have resulted in convictions without published opinions. Some of those indictments are described in III Loss, *Securities Regulation*, *supra*, at 1449 n.15; VI Loss, *Securities Regulation*, *supra*, at 3559.

tive course of conduct alleged in the indictment was forbidden.[54]

2. This case, however, presents no abstract question about the adequacy of potential notice, derived from statute books or judicial opinions. Petitioner received explicit personal notice. As the court of appeals pointed out, "[f]ew malefactors receive such explicit warning of the consequences of their conduct" (Pet. App. A17). Warning posters appeared throughout petitioner's place of employment, stating in large, bold-face print: "You are forbidden to use any information learned from customer's copy * * *. [Y]ou are liable to criminal penalties of 5 years in jail and $10,000 fine for each offense." See pages 5-6, *supra*. Those warnings were communicated to all employees at Pandick Press through other forms of personal notification, as discussed above. *Ibid.*[55]

The district court charged the jury that it could not convict petitioner unless it believed that he acted willfully, deliberately, and intentionally, with aware-

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[54] As an example of the purported unforeseeability of the court of appeals' decision, petitioner points out that a "judge's clerk" would be prohibited by that decision from buying stock on the basis of material non-public information obtained from his or her position (Br. 43 n.19). For example, a clerk aware of a forthcoming antitrust ruling could profitably purchase securities or sell them short. That this conduct is prohibited by the statute, we submit, is not a surprising consequence. Cf. *United States* v. *Peltz*, 433 F.2d 48, 52 n.4 (2d Cir. 1970).

[55] Petitioner admitted on the witness stand that he knew that his conduct was wrongful and in violation of SEC requirements. See pages 10-11, *supra*.

ness that his conduct was wrongful.[56] See pages 11-13, *supra*. The court also instructed the jury that the central issue in the case was petitioner's "state of mind." It directed the jury to consider (Tr. 692):

> Had Mr. Chiarella not seen the notices posted next to his time clock and elsewhere for many months, as he testified? Or was he not telling the truth about these notices, as the government urges, in order not to reveal to you his awareness of possible criminal penalties attached to his conduct.

The jury's guilty verdict establishes that petitioner knew that his conduct was wrongful. The jury did not choose to believe that he had never read the signs warning of criminal liability. In the words of the district court at petitioner's sentencing hearing, petitioner's claim of ignorance of criminal penalties was "perjury beyond a reasonable doubt" (Pet. App. A17 n.18). In light of the jury's finding of willful and knowing misconduct, there is no question in this case of convicting a defendant for engaging in practices that he believed to be proper.[57]

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[56] Petitioner complains that not all of the legal analysis contained in the court of appeals' decision was included in the charge to the jury (Br. 46-47). But the jury was simply required to find the facts in the case: whether petitioner behaved as charged in the indictment, and whether his conduct was willful and knowing. Whether the conduct charged in the indictment and proven by the government at trial constitutes a violation of the statute and rule presented a legal question for the court.

[57] Petitioner argues that he believed that he was justified in behaving as he did because he observed tender offerors making open market purchases prior to announcement of

3. The decisions of this Court have consistently sustained prosecutions under criminal statutes containing general prohibitory language when the defendant's conduct is fairly encompassed by the statute and mens rea is proven by the government. This is true even when the precise coverage of the statute is subject to debate. For example, in *Nash* v. *United States*, 229 U.S. 373, 377 (1913), the Court sustained a criminal indictment charging a restraint of trade illegal under the Sherman Act's "rule of reason." [58] Similarly, in *United States* v. *National Dairy Products Corp.*, 372 U.S. 29, 31-36 (1963), the Court held that the defendants received fair notice in a prosecution for sale of goods at "unreasonably low prices." The court dismissed the argument that prosecution under this general statutory standard was unfair, noting that the defendants could not be convicted unless the government proved mens rea. See also *United States* v. *United States Gypsum Co.*, 438

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their offers (Br. 48 n.21). The short answer to that assertion is that petitioner argued this point to the jury, which refused to credit it. The jury determined (by its verdict) that petitioner realized that *his* conduct was wrongful, regardless of the propriety of the behavior of other persons.

[58] See also *Omaechevarria* v. *Idaho*, 246 U.S. 343, 348 (1918) *Hygrade Provision Co.* v. *Sherman*, 266 U.S. 497, 501-503 (1925); *Gorin* v. *United States*, 312 U.S. 19, 27-28 (1941); *United States* v. *Ragen*, 314 U.S. 513, 523-524 (1942); *United States* v. *Petrillo*, 332 U.S. 1, 5-8 (1947); *Boyce Motor Lines, Inc.* v. *United States*, 342 U.S. 337, 340-342 (1952), all rejecting fair notice arguments under statutes containing prohibitions expressed in general terms, where the offense required proof of mens rea.

U.S. 422, 438-441 (1978), holding that the government may obtain a criminal conviction in a "rule of reason" antitrust case if it proves that the defendants acted with knowledge that their actions were likely to produce anticompetitive effects.[59]

Under these authorities, petitioner's "fair notice" claim is untenable. The government proved beyond a reasonable doubt that petitioner engaged in conduct that falls within the prohibition of Section 10(b). The government also proved that petitioner acted willfully and knowingly, with the realization that his behavior was wrongful. In these circumstances, even though petitioner's conduct may not have precisely duplicated that involved in prior cases, and even though the prohibitory language of Section 10(b) and Rule 10b-5 is general in scope, his conviction was properly sustained. See *United States* v. *Naftalin*, *supra*, slip op. 10. Petitioner was "given clear notice that a reasonably ascertainable standard of conduct is mandated; it [was] for him to insure that his actions [did] not fall outside the legal limits." *United States* v. *Powell*, 423 U.S. 87, 92 (1975).

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[59] *Bouie* v. *City of Columbia*, 378 U.S. 347 (1964), relied on by petitioner (Br. 44-45), has no pertinence here. In that civil rights demonstration case, involving First Amendment issues, the judicial decision under review contradicted the literal text of the criminal statute that was the basis for the prosecution. The Court held that the defendants could not have foreseen such a perverse construction. As we have noted, the prohibitory statute here in question embraces all fraudulent schemes, including the scheme practiced by petitioner. There is no repugnance between the decision below and the statute.

4. The government obtained an indictment in this case to vindicate the deterrent purposes of the Act. As the evidence in this case disclosed, petitioner made over $30,000 in illegal profits. He did so through methods that approximate theft—"conversion," in the words of the court of appeals, or "embezzlement" in the words of the district court. He did so in the face of explicit warnings that his conduct would result in criminal liability. An injunction or disgorgement order is generally not a sufficient sanction to deter and punish deliberate misconduct of this kind. Such sanctions merely return the wrongdoer to the position he would have occupied if he had not engaged in the scheme to defraud. Under all the circumstances, petitioner's 30-day prison sentence, accompanied by probation, certainly was not unwarranted in light of the severity of his offense. Any lesser sanction would invite others to repeat the highly profitable fraud in which he engaged.

III. THE DISTRICT COURT CORRECTLY CHARGED THE JURY ON THE STATE OF MIND ELEMENT OF PETITIONER'S OFFENSE

Petitioner contends that the district court erred by refusing to instruct the jury that the government must prove a specific intent to defraud or deceive (Br. 49-53). He does not dispute that the district court's charge complied with Section 32(a) of the Act, 15 U.S.C. 78ff(a), which provides that any person who "willfully violates any provision of this chapter, or any rule or regulation thereunder * * *" is guilty of a criminal offense. Rather, he argues that the court was required to charge the jury "*both* that intent to defraud was required before a * * * violation could be found and that if found, such violation was a crime if determined to be a willful violation * * *" (Br. 52-53; emphasis in original). He asserts that this two part charge on mens rea is mandated by the Court's decision in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976).

As noted on pages 11-13 above, the district court instructed the jury that it could not convict petitioner unless it found that he engaged in the scheme to defraud alleged in the indictment and did so "willfully and knowingly" (Tr. 682, 687, 688, 690). The court explained that the government must prove that petitioner acted "intentionally" and "deliberately," rather than through "negligence or inadvertence" (Tr. 688). The court emphasized to the jury that knowing and willful misconduct requires proof that petitioner acted with "a realization * * * that he was doing a wrongful act" and that "the knowingly wrongful act involved a significant risk of effecting the violation that occurred" (*ibid.*). The court declined to supplement these instructions on mens rea with petitioner's requested charge on specific intent to defraud (J.A. 831a): [60]

> Intent to defraud means the specific intent to deceive, cheat or trick someone. And, an intent

[60] "J.A." refers to the Joint Appendix filed in the court of appeals.

> to deceive, before being considered the specific intent which satisfies the statute, must be coupled with what may be best described as an evil ambition to injure someone and deprive him of something of value.

As we demonstrate below, the district court properly refused to give this additional charge. Neither Section 32(a) nor Section 10(b) of the Act requires the government to prove that the defendant entertained "an evil ambition to injure someone."

1. This Court's decision in *Ernst & Ernst* v. *Hochfelder*, *supra*, held that in a private damage action under Section 10(b) and Rule 10b-5 the plaintiff must plead and prove scienter and that proof of "negligence" would not suffice. The Court described scienter as a mental state "embracing intent to deceive, manipulate, or defraud." 425 U.S. at 194 n.12. Although scienter "embraces" intent to defraud, it also embraces knowing and willful misconduct;[61] moreover, as the Court pointed out, it may also embrace "reckless" conduct. *Ibid.*

An analysis of *Hochfelder* demonstrates that the Court held not that Section 10(b) requires specific intent to defraud, but rather that culpability greater than mere negligence must be shown. The plaintiffs in *Hochfelder* brought suit against the defendant auditors on the theory that they aided and abetted the fraud of the president of a brokerage house

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[61] The Latin term "scienter" means "knowingly" or with "guilty knowledge." *Black's Law Dictionary* 1512 (Rev. 4th ed. 1968); *Bouvier's Law Dictionary* 3013 (3d rev. 1914).

through "negligent nonfeasance" (425 U.S. at 190). The question before the Court was "whether scienter is a necessary element of such a cause of action, or whether negligent conduct alone is sufficient" (*id.* at 197). In concluding that negligence alone would not suffice, the Court noted that the language of Section 10(b) was aimed at "knowing or intentional misconduct" (*ibid.*), a "type of conduct quite different from negligence" (*id.* at 199). The Court also pointed out that the language of the statute was inconsistent with imposition of liability "for wholly faultless conduct" (*id.* at 198) and that the legislative history demonstrates that Congress intended to prohibit conduct involving "some element of scienter" rather than "negligent conduct alone" (*id.* at 201). Congress intended Section 10(b) to apply in cases where the defendant "has not acted in good faith" (*id.* at 206). Due to the limited scope of its holding, the Court left open the question whether "reckless" conduct would suffice to maintain an action under Section 10(b) (*id.* at 194 n.12).[62]

Thus, the *Hochfelder* case lends no support to petitioner's claim that "specific intent to defraud" is required by the statute. To the contrary, the Court's repeated references to states of mind other than specific intent (including knowing and bad faith con-

[62] The Court also left open the question whether scienter must be proven in an SEC civil enforcement proceeding. See 425 U.S. 194 n.12.

duct) support the traditional view that proof of guilty knowledge is sufficient.[63]

Significantly, the pre-*Hochfelder* decisions that the Court relied on (425 U.S. at 194 n.12) recognize that liability extends to "knowing, wilful and reckless conduct." See, *e.g.*, *Clegg* v. *Conk*, 507 F.2d 1351, 1361-1362 (10th Cir. 1974), cert. denied. 422 U.S. 1007 (1975); *Lanza* v. *Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973) (en banc); *SEC* v. *Texas Gulf Sulphur Co.*, *supra*, 401 F.2d at 868 (Friendly, J., concurring). Similarly, the common law definition of scienter extended to conduct that was knowing, willful or reckless.[64] Finally, the appellate court de-

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[63] Indeed, even if petitioner might have been entitled to an additional instruction on intent, to clarify the issue for the jury, he was not entitled to the instruction he requested. "Specific intent" to defraud has never included a particular design to cause injury. "The fact that the defendant was disinterested, that he had the best of motives, and that he thought he was doing the [victim] a kindness, will not absolve him from liability, so long as he did in fact intend to mislead." Prosser, *supra*, § 107, at 700. The district court was not obliged to give the jury an instruction that misstated the law. See 2 C. Wright, *Federal Practice and Procedure* (Criminal) § 482 at 278-279 (1969 ed.) (collecting cases); see also *United States* v. *Lam Lek Chong*, 544 F.2d 58, 68 (2d Cir. 1976).

[64] See Bucklo, *The Supreme Court Attempts to Define Scienter under Rule 10b-5: Ernst & Ernst* v. *Hochfelder*, 29 Stan. L. Rev. 213, 229 (1977) (footnotes omitted) ("Even the English case generally credited with establishing the strict intent requirement at common law, *Derry* v. *Peek* [14 A.C. 337 (1889)] purported to allow liability when the representation is 'made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false.'" Accord, W. Prosser, *Law of Torts*, § 107, at 699-701 (4th ed. 1971). 1 Harper & James, *supra*, § 7.3, at 533-535.

cisions since *Hochfelder* have uniformly held that a specific intent to defraud is not required.[65]

In sum, nothing in *Hochfelder* or the authorities that preceded or followed it supports petitioner's ar-

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[65] See *Coleco Industries, Inc.* v. *Berman,* 567 F.2d 569, 574 (3d Cir. 1977), cert. denied, No. 77-1725 (Oct. 2, 1978) ("plaintiff may recover under Rule 10b-5 for misrepresentations that are recklessly made as well as those made with conscious fraudulent intent"); *First Virginia Bankshares* v. *Benson,* 559 F.2d 1307, 1314 (5th Cir. 1977), cert. denied, 435 U.S. 952 (1978) ("[t]he defendant must know of the falsity of the information, or must act in reckless disregard of its falsity, or must intend to deceive"); *Sundstrand Corp.* v. *Sun Chemical Corp.,* 553 F.2d 1033, 1045 (7th Cir.), cert. denied, 434 U.S. 875 (1977) ("recklessness should be viewed as the functional equivalent of intent"); *Sanders* v. *John Nuveen & Co.,* 554 F.2d 790, 792 (7th Cir. 1977) ("'reckless behavior' can be sufficient to constitute scienter"); *Wright* v. *Heizer Corp.,* 560 F.2d 236, 251 (7th Cir. 1977) (cites with approval the recklessness standard in *Sundstrand Corp.* v. *Sun Chemical Corp., supra,* and *Sanders* v. *John Nuveen & Co., supra*); *Rolf* v. *Blyth, Eastman Dillon & Co.,* 570 F.2d 38, 46 (2d Cir.), cert. denied, No. 78-560 (Dec. 4, 1978) ("*Hochfelder* left intact our rule that recklessness is a form of scienter in appropriate circumstances"); *Nelson* v. *Serwold,* 576 F.2d 1332, (9th Cir.), cert. denied, No. 78-182 (Nov. 13, 1978) ("Congress intended the ambit of § 10(b) to reach a broad category of behavior, including knowing or reckless conduct"); *Edward J. Mawod & Co.* v. *SEC,* 591 F.2d 588, 596 (10th Cir. 1979) ("*Hochfelder* does not require that there be premeditated malice. It recognized that the carrying on of manipulative or deceptive device or contrivance was itself evidence that knowledge existed."); *Mansbach* v. *Prescott, Ball & Turben,* [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,861, at 95,526 (6th Cir. 1979) ("recklessness constitutes sufficient scienter") *McLean* v. *Alexander,* [Current] Fed. Sec. L. Rep. (CCH) ¶ 96,879, at 95,601, 95,605 (3d Cir. 1979) ("reckless conduct is actionable under Section 10(b)").

gument that the government must prove a specific intent to defraud some victim. See *United States* v. *Charnay*, 537 F.2d 341, 351, 357-359 (9th Cir.), cert. denied, 429 U.S. 1000 (1976), rejecting the assertion that *Hochfelder* changes the traditional "willfulness" standard required by Section 32(a) of the Securities Exchange Act.[66] As the courts below recognized, a charge to the jury that the government must prove that the defendant acted willfully and knowingly, with a realization that his conduct is wrongful and likely to produce the violation that results, fully comports with the requirements of *Hochfelder* and the criminal penalty section of the Act.

2. In addition to its lack of support in statutory or case authority, petitioner's proposed instruction that the government must prove "an evil ambition to injure someone" has no logical application in a case of this kind. Persons trading on the basis of material non-public information could not be proceeded against by the government in either criminal or civil enforcement actions if Section 10(b) required such proof. By hypothesis, traders in petitioner's position deal through their brokers on a securities exchange. They do not know who sells them securities or who buys securities from them. In these circumstances, persons trading on non-public information would almost never entertain "an evil ambition to injure

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[66] The "willfulness" standard prescribed by Congress is described in *United States* v. *Peltz*, 433 F.2d 48, 54-55 (2d Cir. 1970), cert. denied, 401 U.S. 955 (1971), and *United States* v. *Dixon*, 536 F.2d 1388, 1395-1397 (2d Cir. 1976).

someone." Their sole objective would be to make a quick profit, and not to get caught. If the rule against trading on material non-public information is to be enforced at all, it must embrace situations in which the defendant acts deliberately and intentionally in making a secret profit, with knowledge that the information that he uses is non-public and with the realization that he is acting wrongfully.

In the present case, petitioner stipulated that he did not disclose the material information that he used. He admitted that he learned the information by decoding confidential documents. He told his broker that he wanted to make a quick profit, and the evidence showed that his quick profit was substantial. He admitted on the witness stand that he knew that his conduct was wrongful. See pages 9-10, *supra*. In sum, the government proved culpable action and a culpable state of mind. Nothing more could realistically be shown in a case of this kind.

These considerations were recently addressed by the Court in *United States* v. *United States Gypsum Co.*, *supra*. In that case, the Court held that criminal prosecutions under the antitrust laws required proof of *mens rea*, but it rejected the defendants' assertion that a specific intent to inflict injury or to violate the law was also required. The Court noted that when the government proves that the defendants were "consciously behaving in a way the law prohibits," such conduct "is a fitting object of criminal punishment." 438 U.S. at 445. The Court pointed out that "[a] requirement of proof not only of * * * knowledge of likely [anticompetitive] effects, but also of a conscious desire to bring them to fruition or to violate the law would seem, particularly in such a context, both unnecessarily cumulative and unduly burdensome." *Id.* at 446. The Court's analysis of specific intent in *United States Gypsum Co.* is equally applicable here and underscores the correctness of the decision of the court below.

IV. THE DISTRICT COURT CORRECTLY RECEIVED IN EVIDENCE AN ADMISSION MADE BY PETITIONER TO THE NEW YORK DEPARTMENT OF LABOR

Petitioner finally contends (Br. 53-69) that the district court committed reversible error by admitting into evidence a report prepared by an employee of the New York Department of Labor, which summarized petitioner's remarks during an interview concerning unemployment compensation. That summary (Gov. Ex. 12) stated the following:

> I was discharged for violating Company rule re disclosure of client information. The allegation is true. It was a matter of a printing of stock tender offers & I utilized the information for myself. This happened last year & through investigation by S.E.C., the matter came to light & I was discharged.

Petitioner argues (Br. 54) that "[b]oth federal and state interests strongly favor preserving the confidentiality of the statement." As we demonstrate below, neither state nor federal interests support exclusion of this relevant piece of evidence in a federal criminal prosecution.

1. The principal basis for petitioner's argument in favor of exclusion is his assertion (Br. 54) that the law of New York "mandates, in no uncertain terms, confidentiality of information provided in connection with a claim for unemployment insurance." However, the New York statute (N.Y. Lab. Law § 537) (McKinney 1977) prescribes no such absolute privilege. The statute provides in pertinent part (emphasis supplied):

> Information acquired from employers or employees pursuant to this article shall be for the exclusive use and information of the commissioner in the discharge of his duties hereunder and shall not be open to the public nor be used in any court in any action or proceeding pending therein *unless the commissioner is a party to such action or proceeding* * * *. Such information insofar as it is material to the making and determination of a claim for benefits shall be available to the parties affected *and, in the commissioner's discretion, may be made available to the parties affected in connection with effecting placement.*

Thus, the statute itself recognizes that countervailing public need can justify disclosure. If the Commissioner of Labor is a party plaintiff or defendant in a court proceeding, or intervenes therein, the statute authorizes disclosure. And, in the Commissioner's discretion, confidential information may be revealed to third parties in the course of placing unemployed workers.

Significantly, the New York Department of Labor interprets the statute to permit disclosure of confidential files to the Federal Bureau of Investigation. As the witness from the Department of Labor testified, the FBI is given access to "all the records in the office" (Tr. 278-279). Moreover, the report in question was released for use at trial with approval of New York's Commissioner of Labor (J.A. 67a-68a). In light of the practice of the New York authorities to disclose their reports to the agency of the federal government responsible for the investigation of federal crimes, and in view of the fact that the Commissioner of Labor himself authorized release of petitioner's report, the argument that use of the report at trial "frustrates" the policies of the State of New York is wholly untenable.

2. Fed. R. Evid. 402 succinctly states the federal policy in this area. Unless explicitly barred by the Constitution, federal statute, or federal rule, "[a]ll relevant evidence is admissible." Fed. R. Evid. 501 defines the exceptional circumstances in which relevant evidence may be excluded on grounds of privilege:

> Except as otherwise required by the Constitution of the United States or provided by Act of Congress or in the rules prescribed by the Supreme Court * * * the privilege of a witness * * * shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in light of reason and experience.

As the court of appeals recognized (Pet. App. A23), New York's statutory privilege was unknown at common law.[67] Moreover, although petitioner argues that federal constitutional and statutory "policies" support his claim of privilege, he points to no provision of the Constitution or any federal statute or rule that prohibits use of the report.[68]

Because no federal statute, constitutional provision, or common law principle requires exclusion of this relevant evidence, the courts below correctly declined to erect a new federal privilege. As this Court noted in *United States* v. *Nixon*, 418 U.S. 683, 709 (1974): "The need to develop all relevant facts in the adversary system is both fundamental and comprehensive. The ends of criminal justice would be defeated if judgments were to be founded on a partial or speculative presentation of the facts. The very integrity of the judicial system and public confidence in the system depend on full disclosure of all the facts, within the framework of the rules of evidence." The Court added that "[w]hen the ground for asserting privilege * * * in a criminal trial is based only on generalized interest in confidentiality, it cannot prevail over the fundamental demands of due process of law in the fair administration of criminal justice." *Id.* at 713. See also *Herbert* v. *Lando*, No. 77-1105 (Apr. 18, 1979), slip op. 20-21 ("[e]videntiary privileges in litigation are not favored");

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[67] See *Coyne* v. *O'Connor*, 121 N.Y.S. 2d 100, 101 (Sup. Ct. 1953), describing the privilege as a "statutory privilege," rather than "the common-law variety of absolute privilege."

[68] We address petitioner's policy arguments on pages 92-95, *infra*.

United States v. *Nobles,* 422 U.S. 225, 230-231 (1975); *Branzburg* v. *Hayes,* 408 U.S. 665, 690 & n.29 (1972); *United States* v. *Bryan,* 339 U.S. 323, 331-332 (1950); 8 J. Wigmore, *Evidence* §§ 2192, 2193 (McNaughton rev. 1961).[69] The state civil cases relied on by petitioner (Br. 56) do not announce a rule of law that controls the receipt of evidence in this federal criminal prosecution. See *Wolfle* v. *United States,* 291 U.S. 7, 12-13 (1934); *Funk* v. *United States,* 290 U.S. 371, 381-387 (1933).

3. a. Petitioner's contention (Br. 64-65) that the New York privilege has been transmuted into a federal privilege by the Federal Unemployment Tax Act, 26 U.S.C. 3304(a)(16), (17), is insubstantial. As the court below correctly pointed out, petitioner did not raise this claim in the district court as a ground for exclusion of his statement (Pet. App. A22 n.22). For this reason, petitioner waived the claim. See Fed. R. Evid. 103(a)(1). In any event, petitioner's reliance on the statute is misplaced. The Federal Unemployment Tax Act merely specifies conditions

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[69] Consistent with these authorities, the lower federal courts have shown great reluctance to adopt state privileges in federal criminal proceedings, where those privileges lack clear support in federal common law. See, *e.g.*, *In re Special April 1977 Grand Jury,* 581 F.2d 589, 592-593 (7th Cir. 1978), cert. denied, No. 78-403 (Dec. 11, 1978); *In re Grand Jury Impaneled January 21, 1975,* 541 F.2d 373, 378-383 (3d Cir. 1976); *United States* v. *Cortese,* 540 F.2d 640, 642-643 (3d Cir. 1976); *United States* v. *Craig,* 528 F.2d 773, 781-784 (7th Cir.) (Tone, J., concurring), adopted en banc, 537 F.2d 957, cert. denied, 425 U.S. 973 (1976). This Court will address a related question this Term in *United States* v. *Gillock,* No. 78-1455.

for federal approval of state unemployment compensation statutes and provides that the states must offer safeguards to prevent misuse of information obtained by state agencies. It nowhere indicates that information obtained by state agencies administering unemployment compensation statutes must be suppressed in federal criminal trials.[70]

b. Petitioner also argues (Br. 59, 65-66) that proposed Fed. R. Evid. 502 (56 F.R.D. 183, 234-235 (1973)) would have recognized a privilege in favor of persons making reports "required by law to be made" if the relevant state statute so provided. Proposed Rule 502 is irrelevant here for three reasons. First, New York's statute does not withhold information from the federal government in criminal cases, as previously noted. Second, the report in question was not "required by law to be made." Rather, it was the product of petitioner's voluntary application for benefits. Finally, and most fundamentally, the proposed rule of evidence relied on by petitioner was never adopted by Congress. During hearings on the proposed rule, witnesses expressed disapproval of the recognition of state privileges in federal criminal proceedings (see *Rules of Evidence (Supplement)*:

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[70] As the court of appeals observed (Pet. App. A22 n.22), state unemployment compensation statutes providing for disclosure of information to prosecuting authorities have been approved under the Federal Unemployment Tax Act. See Mass. Ann. Laws ch. 151A, § 46 (Michie/Law. Co-op. 1976); Wash. Rev. Code § 50.13.060, 50.13.070 (Supp. 1978). See also 43 Fed. Reg. 51473 (1978), noting the Secretary of Labor's approval of these statutes.

Hearings on the Proposed Federal Rules of Evidence Before the Subcomm. on Criminal Justice of the House Comm. on the Judiciary, 93d Cong., 1st Sess. 47, 49-50 (1973) (views of Senator McClellan)). Congress abandoned the proposed rule in favor of the current version of Rule 501, which provides that privileges in federal criminal cases are defined by the federal common law. See S. Rep. No. 93-1277, 93d Cong., 2d Sess. 6 (1974); H.R. Rep. No. 93-650, 93d Cong., 1st Sess. 8 (1973); H.R. Conf. Rep. No. 93-1597, 93d Cong., 2d Sess. 7-8 (1974). See also *In re Grand Jury Impaneled January 21, 1975*, *supra*, 541 F.2d at 378-383.

c. Petitioner further argues (Br. 66-67) that the policies of the Fifth Amendment bar use of his admission. That contention was not raised in the court below and should not be reviewed here. See *United States* v. *Lovasco*, 431 U.S. 783, 788 n.7 (1977). In any event, petitioner's argument is insubstantial.

Petitioner did not refuse to provide information to the New York Department of Labor on Fifth Amendment grounds or otherwise assert a Fifth Amendment privilege. Under these circumstances, he may not contend that use of his statement infringed the Fifth Amendment. See *Garner* v. *United States*, 424 U.S. 648, 655 (1976) ("[o]nly the witness knows whether the apparently innocent disclosure sought may incriminate him, and the burden appropriately lies with him to make a timely assertion of the privilege. If, instead, he discloses the information sought, any incriminations properly are viewed as not compelled."). See also *United States* v. *Kordel,* 397 U.S. 1, 7-13 (1970) (persons providing answers to interrogatories may not later assert "self incrimination" when those answers are used in a criminal prosecution); *California* v. *Byers,* 402 U.S. 424, 427-431 (1971) (statute requiring disclosure of information for general regulatory purposes does not result in "self incrimination").

Moreover, petitioner was not "compelled" to make any statement. Nor was he ever promised that his statement would be kept confidential—much less offered "immunity" from use of his statements in a criminal prosecution. Compare *New Jersey* v. *Portash,* No. 77-1489 (Mar. 20, 1979), slip op. 9.[71] Unlike taxpayers who are required to file tax returns (*Garner* v. *United States, supra*) or motorists who are required to furnish information about traffic accidents (*California* v. *Byers, supra*), petitioner was not subject to any legal obligation to make a statement. He therefore may not assert that he was forced to incriminate himself. *Garner* v. *United States, supra,* 424 U.S. at 654-656.

4. Finally, petitioner argues that his admission had "the dramatic impact of a written confession"

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[71] Although petitioner took the witness stand and testified at trial, he did not assert that he received any promise of confidentiality or immunity. The employee from the New York Department of Labor who communicated with petitioner and transcribed his statement testified that if petitioner had inquired about the use to which his statement could be put, he would have been informed that it could be turned over to the FBI (Tr. 278-279).

(Br. 68). He makes that assertion despite his recognition that the statement "did not significantly add to the government's evidence" (*ibid.*). We note that petitioner's "confession" consisted simply of a statement that he was fired for violating company rules and an admission that the charge of violating those rules was "true." The government clearly established these undisputed facts by independent proof (see pages 5-11, *supra*). Thus, although relevant and admissible, petitioner's statement was merely cumulative evidence.

Significantly, petitioner's admission said nothing whatsoever about the central issue in the case—the existence of *mens rea*. As petitioner notes (Br. 49), his "sole defense on the merits was that he denied having an intent to defraud." His prior admission was entirely consistent with his position at trial that, although he knew of his company's rules, he did not act with a state of mind sufficiently culpable to give rise to criminal liability. Since the admission had no bearing on petitioner's "sole defense," it is difficult to credit his assertion that it prejudiced him or that it forced him to take the witness stand (Br. 69).[72]

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[72] If, indeed, petitioner had been forced to take the witness stand to rebut the admission, one would expect that he would have presented contradictory evidence. To the contrary, however, he repeatedly admitted both on direct and cross examination that he used confidential client information for trading in the stock market, realizing that this constituted a violation of his company's rules and could lead to discharge (Tr. 475-521).

In sum, receiving petitioner's admission resulted only in duplication of undisputed evidence. The admission did not have any bearing on what petitioner designates as his "sole defense" on the merits. Under these circumstances, even if the district court committed error in receiving the admission, that error could not have affected the outcome of the trial. See *Kotteakos* v. *United States*, 328 U.S. 750, 757-765 (1946).

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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APPENDIX

(Gov. Ex. 18)

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Employee
Signature: ____________________

Dated: ________________

Supervisor
Signature: ____________________