rjm 12/09/86

For my Review

To: Justice Powell
From: Ronald
Re: Carpenter v. United States

In this draft, I have treated the case as presenting one important question: whether petitioners can be convicted under §10(b). An alternate tack would treat the case as raising two questions: whether the misappropriation theory can ever justify a conviction; and whether it can justify a conviction on the facts of this case. I rejected the latter tack because it would play up a reason against granting this case; it is too easy. It seems reasonably clear that this case would be reversed if the Court granted. But this might not resolve the big question, whether misappropriation is a legitimate theory of liability under §10(b). Thus, the Court might have to hear another case to nail the coffin shut on the misappropriation theory.

The imp Q

December 9, 1986

Carpenter v. United States

No. 86-422

JUSTICE POWELL, dissenting from denial of certiorari

Because a divided panel of the Court of Appeals for the Second Circuit has resolved an important question of securities law in a way that conflicts with recent opinions of this Court, I would grant the petition for certiorari with respect to question 1.

I

In this case, the Court of Appeals for the Second Circuit affirmed petitioners' convictions for wire fraud, mail fraud, and securities fraud. Question 1 of the

petition challenges the securities fraud convictions. The convictions rest on a conspiracy involving petitioner Winans, a reporter for the Wall Street Journal, and petitioners Felis and Brant, stockbrokers for the firm of Kidder Peabody. The final party to the conspiracy was petitioner Carpenter, who carried messages from Winans to Felis and Brant. Winans informed Brant and Felis of the dates on which the Wall Street Journal would publish columns discussing particular securities. Advance knowledge of the dates on which certain columns would appear enabled Brant and Felis to profit by trading in anticipation of price changes that would follow publication of the columns. The columns themselves consisted of public information. The only nonpublic

Ronald - State what Petitioners were charged with before we convict them.

information provided by Winans was the publication schedule for the columns.

After a bench trial, the District Court convicted all four petitioners. United States v. Winans, et al, 612 F. Supp. 827 (S.D.N.Y. 1985). On appeal, the Court of Appeals for the Second Circuit affirmed. United States v. Carpenter, et al, 791 F.2d 1024 (1986). In the Court of Appeals' view, petitioners were guilty of criminal securities fraud under the "misappropriation" theory of liability under §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and Rule 10b-5, 17 CFR §240.10b-5. Under this theory, a person is liable under Rule 10b-5 if he misappropriates nonpublic information and then uses the information in connection with the purchase or sale of securities. See Chiarella v. United States, 445 U.S. 222, 239 (1980)

(BRENNAN, J., concurring). The Court of Appeals noted that we left open the question of the legitimacy of the misappropriation theory in Chiarella. But, the court ~~of Appeals~~ noted, ~~the Second Circuit~~ that the Circuit has adopted that theory since our decision in Chiarella. See SEC v. Materia, 745 F.2d 197 (CA2 1984), cert. den., 471 U.S. 1053 (1985); United States v. Newman, 664 F.2d 12 (CA2 1981), affirmed after remand, 722 F.2d 729 (CA2), cert. den., 464 U.S. 863 (1983).

The Court of Appeals rejected petitioners' argument that the misappropriation theory could not be applied in this case because the information was misappropriated not from the corporations whose securities were traded, but from the Wall Street Journal. The court ~~noted~~ believed that our recent opinion in Dirks v. SEC, 463 U.S.

contention,

646 (1983), offered substantial support to petitioners',
but concluded that "[i]t is not accurate to say that Dirks
wrote the book on insider or outsider trading; it wrote
one chapter with respect to one type of fraudulent
trading." 791 F.2d, at 1029 (quoting the District Court's
opinion, United States v. Winans, 612 F. Supp. 827, 842
(S.D.N.Y. 1985)). The Court of Appeals concluded that
Winans' appropriation of the Wall Street Journal's
publication schedules was a fraud condemned by the
securities laws. "Congress apparently has sought to
proscribe ... trading on material, nonpublic information
obtained not through skill but through a variety of
"deceptive" practices, unlawful acts which we term
'misappropriation.'" Id., at 1031. Judge Miner dissented
from the panel's judgment. In his view, §10(b)

> "never was intended to protect the reputation, or enforce the ethical standards, of a financial newspaper. ... [T]he securities fraud provisions were [not] designed to prohibit the type of fraudulent conduct engaged in by these defendants. Such conduct is addressed adequately by the statutes establishing the mail and wire fraud offenses of which the defendants stand convicted." 791 F.2d, at 1037.

II

A comparison of the ~~Second Circuit's~~ of the Ct. of Appeals' opinion in this case with our recent precedents demonstrates the need for examination of the misappropriation theory by this Court. In Chiarella, ~~the Court started its~~ we began our analysis of Rule 10b-5 with the proposition that parties to a business transaction generally do not have an affirmative duty to disclose information about the transaction. The Court noted, however, that a failure to disclose material information could be fraudulent in certain circumstances.

"But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." Id., at 230 (emphasis added). The ~~Court noted that~~ Such a duty applied when corporate insiders traded in the securities of their corporation. In such a case, "the duty arose from (1) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (2) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure." Id., at 227 (citing Cady, Roberts & Co., 40 S. E. C. 907, 912, and n. 15 (1961)).

In Dirks v. SEC, 463 U.S. 646 (1983), we examined the circumstances under which outsiders could be held liable under Rule 10b-5. First, we noted that

> "[u]nder certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes." Id., at 655, n. 14.

Thus, because such outsiders have a fiduciary duty to the shareholders, they cannot purchase securities from those shareholders without first informing them of material information that might influence the decision to purchase or sell the securities.

The Court also noted that even if a particular outsider was not under a fiduciary duty to the corporation's shareholders, he could not trade on information that corporate insiders had disclosed to him

improperly. See id., at 659-660. As the Court explained, "[T]ippee responsibility must be related back to insider responsibility by a necessary finding that the tippee knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information . . ." Id., at 661 (emphasis added) (quoting In re Investors Management Co., 44 SEC 633 (1971)).

Applying these principles to this case, it is difficult to understand how any of the petitioners were guilty of criminal securities fraud. The Court of Appeals ~~opinion discusses~~ ~~identifies~~ found no fiduciary relationship between any of the petitioners and the parties from whom they purchased securities. The only fiduciary duty discussed by the ~~Second Circuit~~ court is petitioner Winans' ~~fiduciar~~y duty to the

Wall Street Journal. But that fiduciary duty is irrelevant to an action under Rule 10b-5. The inquiry under that section must focus on "petitioner's relationship with the sellers of the ... securities .... [Petitioner] was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions." Chiarella, 445 U.S., at 232-233. Because the petitioners had no fiduciary obligation to disclose the information before dealing in the securities, our precedents do not support their convictions under §10(b) and Rule 10b-5.

III

In Chiarella, the Court noted the existence of the misappropriation theory, but refused to address its merit. See Chiarella, 445 U.S., at 236-237; id., at 237-238 (STEVENS, J., concurring); id., at 238-239 (BRENNAN, J., concurring in the judgment). The question is important, because the misappropriation theory broadens substantially the ambit of criminal liability under the securities laws. The Second Circuit has had three occasions to address the theory since we left this question open in Chiarella. On each occasion, it has firmly embraced the theory.

Because the Second Circuit includes New York, its decision of this question is important to the securities industry. In my view, this presents "an important

question of federal law which has not been, but should be, settled by this Court." S. Ct. R. 17.1(c). The time has come for this Court to resolve the issue. I dissent from the Court's denial of certiorari in this case.