Grant

If not granted I'll write.

See Ronald's memo with which I agree

CA 2, by approving criminal convictions of a Wall Street Journal reporter, a news clerk, & a Kidder-Peabody stock broker, substantially extended § 10b & Rule 10b-5 & criminalized conduct that involved no insider trading.

Altho no conflict, Q is important

PRELIMINARY MEMORANDUM

December 5, 1986 Conference
List 1, Sheet 2

No. 86-422

Carpenter et al. (journalist convicted of securities fraud)	Cert to CA2 (Pierce, Mansfield; Miner [diss. in part])
v.	
United States	Federal/Criminal Timely

1. SUMMARY: Petrs contend that the CA erred in concluding that the misappropriation of nonpublic information from the Wall Street Journal in connection with the purchase and sale of securities discussed in that newspaper can serve as the predi-

See memo

cate to criminal liability (1) for securities fraud, and (2) for mail and wire fraud.

2. FACTS AND DECISIONS BELOW: Petr Winans was a reporter for the Wall Street Journal and one of two full-time writers of the "Heard on the Street" column, a widely read and influential column in the Journal. Petr Carpenter worked as a news clerk at the Journal. Petr Felis was a stockbroker for Kidder Peabody, as was Peter Brant, who later pleaded guilty and became a government witness.

It was the practice of Dow Jones, the parent company of the Journal, to distribute to all new employees a forty-page manual, seven pages of which was devoted to the company's conflicts of interest policy. The evidence at trial showed that both Winans and Carpenter knew that company policy deemed all news material gathered by an employee during the course of employment to be company property and that company policy required employees to treat nonpublic information learned on the job as confidential.

In October 1983 Winans participated in a scheme with Brant and later Felis and Carpenter in which Winans agreed to provide the stockbrokers (Brant and Felis) with securities-related information that was scheduled to appear in "Heard" columns; based on this advance information the two brokers would buy or sell the subject securities. Carpenter served as the messenger between the conspirators. During 1983 and 1984, defendants made prepublication trades on the basis of their advance knowledge of approximately 27 "Heard" articles, most of which were written by Winans.

Generally, Winans would inform Brant of the subject of the article the day before its publication. The defendants made approximately $690,000 from the scheme.

Petrs were found guilty of securities and mail and wire fraud after a 20-day bench trial (S.D.N.Y., Stewart, J.). In finding petrs guilty of securities fraud, the DC stated that "one who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage violates section 10(b) and Rule 10b-5." In this case, "[w]hat made the conduct... a fraud was that Winans knew he was not supposed to leak the timing or contents of his articles or trade on that knowledge... Winans breached the [company's] policy and he knew he was breaching it." Finding that the government had also shown mail and wire fraud, the DC determined that Winans' breach of fiduciary duty and failure to disclose material information to the Journal served as an appropriate basis for the prosecution. The court noted Winans' "awareness that he had a duty not to disclose the content and timing of publication of the column as well as a duty to disclose, at the very least, any leaks of the column." The scheme involved "the fraudulent misappropriation or theft of the Journal's property," and the petrs "were hardly unaware of the potentially devastating harm that their fraudulent acts could cause the WSJ." Finally, the DC held that the telexing of articles for printing and the mailing of the Journal to subscribers were "integral parts of the scheme to defraud."

The CA2 affirmed. Regarding the securities fraud count, in Chiarella v. United States, 445 U.S. 222 (1980), this Court left

open the question of whether the misappropriation of material, nonpublic information could serve as the basis for criminal liability under section 10(b) and Rule 10b-5. Since then, the CA2 had cast its vote in favor of the misappropriations theory. See SEC v. Materia, 745 F.2d 197 (CA2 1984), cert. denied, 105 S.Ct. 2112 (1985); United States v. Newman, 664 F.2d 12 (CA2 1981), aff'd after remand, 722 F.2d 729 (CA2), cert. denied, 464 U.S. 863 (1983). Petrs argue that Materia and Newman are distinguishable, because the information was misappropriated by employees who owed a duty of confidentiality not only to their employers, but also to their employer's clients, the corporations whose securities were traded. The question raised by this case is whether the misappropriation theory also applies to individuals who are not corporate insiders or so-called "quasi-insiders," see Dirks v. SEC, 463 U.S. 646, 655 n. 14 (1983).

The CA concluded that it does. The misappropriation theory broadly proscribes the conversion by 'insiders' or others of material non-public information in connection with the purchase or sale of securities. Dirks is not to the contrary. Although that case disapproved of certain trading by insiders or quasi-insiders who owe a fiduciary duty to investors, it did not "write the book on insider or outsider trading; it wrote one chapter with respect to one type of fraudulent trading." Rule 10b-5 broadly prohibits "any person," acting "directly or indirectly," from employing "any act, practice, or course of business which operates as a fraud upon any person." The repeated use of the word "any" evidences Congress' intention to draft the Rule broadly. The legis-

lative intent of the 1934 Act also shows that the antifraud provision was intended to be broad in scope, encompassing all "manipulative and deceptive practices which have been demonstrated to fulfill no useful function." S. Rep. No. 792, 73rd Cong., 2d Sess., 6 (1934).

Congressional statements made in connection with the Insider Trading Sanctions Act of 1984 also show that Congress clearly understands its predecessors to have delineated illegal conduct not only based on relationships to corporations and duties arising thereunder (e.g., Dirks), but also trading on material, nonpublic information "obtained not through skill but through a variety of 'deceptive' practices, unlawful acts which we term 'misappropriation.'"

The misappropriations theory does not resurrect the "parity of information" theory rejected by Chiarella, which predicated liability upon mere use of information not available or accessible to others. One may gain a competitive advantage through conduct constituting skill, foresight, etc.; however, one may not gain such advantage by conduct constituting secreting, stealing, etc.

The "in connection with" standard language of the Rule is satisfied here. The misappropriated information had no value whatsoever to petrs except "in connection with" their subsequent purchases and sales of securities. The sole purpose of the scheme was to purchase and sell securities. Those who purchased or sold securities without the misappropriated information would not have purchased or sold, at least at the transaction prices, had they

had the benefit of that information. Investors are endangered equally by fraud by non-insider appropriators as by fraud by insiders.

It was not anomalous to hold an employee liable for acts that his employer could lawfully commit. While the Journal might perhaps lawfully disregard its own confidentiality policy, it would be unlikely to undermine its own valued asset, its reputation. Employees should be barred from destroying the employer's reputation by misappropriating their employer's informational property. Petrs' argument illogically casts the thief and the victim in the same shoes.

Regarding the wire and mail fraud counts, confidential and nonpublic information may constitute fraudulently misappropriated "property" under the mail fraud statute. Although not every breach of an employee's fiduciary duty to his employer constitutes mail or wire fraud, the "concealment by a fiduciary of material information which he is under a duty to disclose to another under circumstances where the non-disclosure could or does result in harm to another is a violation of the mail fraud statute." Here, the scheme in breach of the employee's duty of confidentiality meets these requirements, and threatened to harm the Journal's reputation for professionalism and integrity.

To "cause" a use of the mails and wires, it is sufficient that petrs knew that the use of interstate mail and wire services was a reasonably foreseeable consequence of the scheme. Certainly petrs understood that the mailings and wirings associated with distribution of the Journal was a customary part of that busi-

ness. Moreover, while the mailings and wirings did not result from the fraud itself, their foreseeability and centrality to the scheme were sufficient predicates to allow a conclusion that they had violated the mail and wire fraud statutes.

Judge Miner dissented from the affirmance of the securities fraud convictions. Previous misappropriation cases have involved the taking and use of nonpublic, confidential <u>securities-related</u> information by those who obtained that information through special relationships with their sources of knowledge. To say that the "publications schedule" of the Journal was the nonpublic, confidential information stolen by the petrs is to extend the sweep of section 10(b) and Rule 10b-5 beyond all reasonable bounds. Knowledge of publication dates is simply not the special securities-related knowledge implicated in the misappropriation theory.

While the proscription of fraudulent and deceptive practices in connection with the purchase and sale of securities is a broad one, "it never was intended to protect the reputation, or enforce the ethical standards, of a financial newspaper. Harm to reputation, rather than to securities market or market participants, never has been viewed as a subject for redress under Rule 10b-5.

3. <u>CONTENTIONS:</u> <u>Petr</u>: (1) This case is unlike other misappropriation cases, because Winans was not an insider, or a "temporary insider," nor did he receive information from an insider. The only duty in this case arose out of internal corporate workrules designed to protect the corporation's journalistic integrity. There was no securities-related fiduciary duty, nor a

securities-related injury. Applying the misappropriation theory to such a case creates a legal anomaly: an employee commits securities fraud by trading on certain information, while his employer can trade on the very same information without violating the securities laws. From the perspective of the investor, and as concerns the securities markets, the impact of the employer's and employee's conduct is the same.

The purpose of the securities laws is to protect investors, not reputations. See Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). However, the CA's rule does not add any protection. The ordinary investor has no way of knowing whether a journalist is barred by the publisher's internal rules from advance trading. Moreover, the information at issue here does not bear on the integrity of the market. The publication schedule had nothing to do with the value or investment-worthiness of any of the stocks that were the subject of Winans' columns, and does not even rise to the level of "outside" or "market" information. By using the federal securities laws to impose criminal penalties for breaches of internal corporate policy, the CA has caused tremendous confusion and doubt as to what types of information and relationships are covered by the Exchange Act. The Court should consider the question reserved in Chiarella - under what circumstances the misappropriations theory is a viable basis for liability.

(2) The decision upholding the mail and wire fraud convictions is erroneous on three grounds. First, it substitutes the "vacuous concept of 'breach of fiduciary duty' for the statutory requirement of fraud." Doing so gives every employer the power to

decide what acts are indictable as felonies and thereby usurps a role reserved for the legislature. The practical effect of criminalizing every workrule breach is to give prosecutors almost total discretion in determining, after the fact, what conduct constitutes a crime and who should be criminally prosecuted.

Second, the decision improperly extends the "deprivation of intangibles" approach beyond all bounds. If a concept as loose as "reputation for professionalism" can satisfy the harm requirement of the statutes, then the requirement has effectively been eliminated _sub silentio_.

Third, the alleged scheme did not "cause" the mailings for the "purpose" of executing their fraudulent scheme. Neither the timing nor the accuracy of the columns was affected: the wire transmission in form and content is exactly what it would have been in the absence of Winans' breach. Nor were the mailings directed to the only alleged victim of the fraud, the Journal; indeed, on the theory of the prosecution, the "fraud" - consisting of Winans' unauthorized use of the Journal's publication schedule - was completed before any relevant mailing or wiring occurred. Although petrs took advantage of the mailings and wirings, that does not satisfy the statutory requirement. See _United States_ v. _Green_, 786 F.2d 247, 256 (CA7 1986) (Posner, J., dissenting) ("the distinction between mailing a letter to execute a fraud and merely taking advantage of a criminal opportunity created by a letter sent for a lawful purpose is at the heart of _Parr_ v. _United States_, 363 U.S. 370 (1960)).

This decision marks the furthest bounds reached in the "limitless" expansion of the mail and wire fraud statutes criticized by judges in many CAs. See United States v. Hewes, 729 F.2d 1302, 1322 (CA11 1984), cert. denied sub nom. Caldwell v. United States, 105 S.Ct. 790 (1985); United States v. Lemire, 720 F.2d 1327, 1335-36 (CADC 1983) (rejecting government theory that "would criminalize any intentional undisclosed breach of duty to an employer"), cert. denied, 467 U.S. 1226 (1984); United States v. Margiotta, 688 F.2d 108, 139-44 (CA2 1982) (Winter, J., dissenting), cert. denied, 461 U.S. 913 (1983); United States v. Bronston, 658 F.2d 920, 930-33 (CA2 1981) (Van Graafeiland, J., dissenting), cert. denied, 456 U.S. 915 (1982).

Resp: (1) The CAs have not widely considered the legal issues raised by the securities fraud claim. The CA2 is the only CA that has addressed the "misappropriations theory," and the question of the misappropriation of information from a nonparticipant in the market is one of first impression. Consideration of the issue by this Court therefore would be premature.

On the merits, the CA was correct. Petrs' conduct amounts to a "fraud or deceit" under Rule 10b-5, which is "a catchall clause to enable the Commission to deal with new manipulative or cunning devices." Ernst & Ernst, 425 U.S., at 203. In other areas of the law, "deceitful misappropriation of confidential information by a fiduciary, whether described as theft, conversion, or breach of trust, has consistently been held to be unlawful." Newman, 664 F.2d, at 18. This Court has noted that "misappropriation is a

'garden variety' type of fraud." Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 11 n. 7 (1971).

The CA also correctly found that the fraud occurred "in connection with" their purchases and sales of securities. Obviously the sole purpose of petr's misappropriation was to trade securities using the stolen information. This Court has twice suggested that trading on misappropriated or illegally obtained information constitutes fraud in violation of Rule 10b-5. See Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 313 n. 22 (1985); Dirks, 463 U.S., at 665. See also Chiarella, 445 U.S., at 240 (Burger, C.J., dissenting); id, at 239 (Brennan, J., concurring in the judgment); id, at 245 (Blackmun, J., joined by Marshall, J., dissenting). It does not matter that the Journal was not itself a participant in the market. Rule 10b-5 proscribes any scheme that operates as a fraud "upon any person" "in connection with the purchase or sale of any security." Cf. United States v. Naftalin, 441 U.S. 768, 773 (1979) ("nothing in [section 17(a)(1) of the Securities Act, which has language almost identical to Rule 10b-5] creates a requirement that injury occur to a purchaser"). Moreover, the purpose of petrs' fraud was to obtain an advantage, made possible by their theft, over other buyers and sellers of securities.

There is nothing anomalous in the use of the misappropriation theory against an employee when it could not have been applied against the employer. The fraud triggering application of Rule 10b-5 was the misappropriation of confidential information; whether or not some other legal theory could have been used to

prevent the Journal from using its own information to trade is not presented by this case. It also is incorrect to claim that the misappropriated information is not sufficiently "securities-related" because it did not bear on the "value or investment worthiness" of the stocks mentioned in the Journal. The information stolen plainly was material, and had an immediate effect on the market price of the relevant securities (petrs themselves obviously thought the information was material, because that was the basis for their scheme).

This is not a case of "protecting reputations." Petrs' trading directly undermined the integrity of the securities markets, and is the antithesis of the "open and honest market" for securities that section 10(b) was intended to protect. See Naftalin, 441 U.S., at 775 (the securities laws aim "to achieve a high standard of business ethics... in every facet of the securities industry").

(2) It is revealing that petrs' challenge to their mail and wire convictions is premised almost entirely on dissenting opinions issued by judges in the CA2 and other CAs. The majority decisions in those cases show that the CA's holding involved the unexceptional application of settled law.

The CAs have uniformly held that the type of fraud which is perpetrated through a breach of fiduciary duty owed by an employee to his employer is actionable under the mail and wire fraud statutes, at least where the employee fails to disclose relevant information to the employer. See, e.g., United States v. Weiss, 752 F.2d 777, 784 (CA2), cert. denied, 106 S.Ct. 308 (1985);

United States v. Lemire, 720 F.2d 1327, 1335-36 (CADC 1983), cert. denied, 467 U.S. 1226 (1984); United States v. Feldman, 711 F.2d 758, 763 (CA7), cert. denied, 464 U.S. 939 (1983); United States v. Conner, 752 F.2d 566, 572 (CA11), cert. denied sub nom. Taylor v. United States, 106 S.Ct. 72 (1985). This is not a case involving "trivial" or "technical" breaches of fiduciary duty. Apart from violating the securities laws, the actions are similar to conduct that would be criminal in many jurisdictions, and have long been condemned as fraudulent.

The harm to the Journal is sufficient to support a conviction under the mail and wire fraud statutes under the uniform holdings of the CAs. The CAs have made it clear that a scheme contemplating injury even to an intangible interest of the victim, such as one defrauding an employer of the loyal services of its employee, falls within the ambit of the statutes. See, e.g., Lemire, 720 F.2d, at 1337; United States v. Margiotta, 668 F.2d 108, 121 (CA2 1982), cert. denied, 461 U.S. 913 (1983); United States v. Bohonus, 628 F.2d 1167, 1172 (CA9), cert. denied, 447 U.S. 928 (1980). Moreover, the Journal did not only suffer injury to its intangible interest in its reputation; the fraudulent misappropriation also amounted to a theft of the Journal's confidential information, and that alone is sufficient to satisfy the injury requirement.

Finally, the petrs' conduct satisfies the "cause" requirement of the statutes. Where the defendant delivers materials for transportation interstate through the wires and mails, with the intention of using those materials (once transported) in a scheme

to defraud, the requirements of the statutes are satisfied. See United States v. Muni, 668 F.2d 87, 89 (CA2 1981); United States v. Castor, 558 F.2d 379, 385 (CA7 1977), cert. denied, 434 U.S. 1010 (1978). The cases relied upon by petr merely held that the mail fraud statute was not satisfied when there was not a sufficient connection between the mailing and the execution of the scheme. Here, Winans introduced columns into the interstate mails and wires with the intention of using those columns to perpetrate a fraud, and knowing that the columns would not be published if he disclosed his breach of duty.

Amicus Securities Industry Association (supports petrs): The CA's decision conflicts with Chiarella and Dirks. It also conflicts with the purpose of section 10(b) and Rule 10b-5, because neither the fiduciary duty breached, the potential injury, nor the information traded upon is within the zone of interest of the federal securities laws.

Amicus Reporters Committee for Freedom of the Press (supports petrs): The CA's ruling implicates First Amendment concerns, because the government is now authorized to regulate aspects of the reporter-editor relationship by enforcing vague ethical obligations of a reporter to his employer. The disclosures required by the misappropriation theory may have a chilling effect on editors, because publication is a critical element of securities fraud. If a journalist discloses his prior trading to his editor, the editor's decision to proceed with publication might be considered aiding and abetting. There also may be concerns about whether to publish if a reporter, in gathering sto-

petrs apparently would not be criminally liable under Rule 10b-5. This leads to odd results. Winans' sources might be able to trade on their knowledge that there would be an upcoming articles; reporters who work for newspapers without the Journal's restrictions might be able to trade as Winans did; and the Journal itself might have been able to do so. It is hard to see why the securities markets are threatened more by one of these trades than by another. Resp's emphasis on the fact that the information here was obtained illegally does not appear to address why the integrity of the securities industry (rather than that of Winans' employer) was implicated.

There are some reasons not to take cert on this question. First, as resp notes, this is a case of first impression, and it might be preferable to wait until the lower courts have more fully addressed the proper scope of the misappropriation theory. On the other hand, it does not seem likely that a split in the CAs will develop any time soon: the CA2 and S.D.N.Y. have applied the misappropriation theory in a number of cases since Chiarella, while no other CA apparently has had an opportunity to address the question. The primary benefit of waiting, therefore, probably would be to see how the theory works its way out in the courts in the CA2. A second reason not to grant cert is that the CA2 may be correct. Section 10(b) and the Rule are broadly written to give the SEC sufficient authority to ensure the integrity of the securities market, and the CA2's decision may be consistent with that purpose. The CA's decision also is not an unreasonable parsing of the language of the Rule.

A final consideration, but one that works in favor of granting cert, is the importance of the issue in the securities industry. The CA's decision appears to expand significantly the scope of potential liability under Rule 10b-5. This case would provide an opportunity for considering under what, if any, circumstances misappropriation is a viable theory of liability under the Rule.

(2) As resp notes, the CA2's decision below is in accord with other lower court decisions interpreting the scope of the mail and wire fraud statutes. Although petrs challenge the "vacuous concept" of "breach of fiduciary duty," the CAs are unanimous in concluding that breach of an employee's fiduciary duty to his employer may form the predicate for a mail or wire fraud conviction. See, e.g., United States v. Conner, 752 F.2d 566, 572 (CA11), cert. denied, 106 S.Ct. 72 (1985); United States v. Bohonus, 628 F.2d 1167, 1172 (CA9), cert. denied, 447 U.S. 928 (1980). The CAs frequently have indicated that something in addition to an employee's breach of fiduciary duty is necessary to impose liability under the wire and mail fraud statutes - for example, the CA2 requires proof "that while under a duty to disclose material information to his employer, an employee failed to do so." United States v. Weiss, 752 F.2d 777, 783 (CA2), cert. denied, 106 S.Ct. 308 (1985). Although the verbal formulas used to describe this "something more" vary among the CAs, see United States v. Lemire, 720 F.2d 1327, 1337 (CADC 1983), cert. denied, 467 U.S. 1226 (1984), petrs do not contend that the result would have been different under any of these standards.

Regarding the adequacy of the harm to the Journal, the CAs have found that a scheme to deprive someone of an intangible can sustain a finding of criminal intent if "they involve intangibles recognized in law as having some independent value to their owners." Lemire, 720 F.2d, at 1337 n. 11. See, e.g., United States v. Louderman, 576 F.2d 1383, 1387-88 (CA9) (scheme to invade privacy by obtaining confidential information from telephone company), cert. denied, 439 U.S. 896 (1978). The DC's finding that the petrs' scheme knowingly placed "in jeopardy probably [the Journal's] most valuable asset - its reputation for fairness and integrity," falls within these bounds. Even if it did not, petrs have not challenged the DC's further finding that the "fraudulent taking and misuse of confidential information stolen from the Journal" was a "theft of valuable property." This finding appears to satisfy the harm requirement.

Finally, most of the cases cited by petrs simply state that mailings which are too remote from a fraudulent scheme will not support a mail fraud charge. The only authority petrs cite to support their argument that a mailing must be affected by the scheme (rather than merely being an integral part of it), is Judge Posner's dissent in United States v. Green, which stresses "the distinction between mailing a letter to execute a fraud and merely taking advantage of a criminal opportunity created by a letter sent for a lawful purpose." In Green, a police employee had the job of mailing notices to the owners of cars involved in illegal accidents. After mailing the notices, Green then attempted to extort bribes from the owners. Judge Easterbrook, writing

for the majority, rejected the dissent's distinction, stating "the causal connection between the mailing and the success of the scheme, not the knavery of the mailings, is what matters." 786 F.2d, at 249.

The incredibly broad reach of the mail and wire fraud statutes, as illustrated by this case, is somewhat disturbing. However, the Court has repeatedly declined to grant cert in previous cases raising these issues, and the decision below does not appear to mark a new departure in the application of the mail and wire fraud statutes. Granting cert on this question would, moreover, require consideration of a number of unresolved issues at the same time: the appropriateness of "breach of fiduciary duty" as a basis for liability; the sufficiency of "intangible" harm; and the scope of the "causation" requirement. Consequently, this case does not appear to warrant cert on this question.

The first question is a possible grant. I do not think that the second question warrants review.

There is a response. Amicus briefs were filed by the Securities Industry Association and by the Reporters Committee for Freedom of the Press et al.

December 1, 1986 Creighton opn in petn