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No. 78-1202

In the Supreme Court of the United States

OCTOBER TERM, 1978

VINCENT F. CHIARELLA, PETITIONER

v.

UNITED STATES OF AMERICA

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

BRIEF FOR THE UNITED STATES IN OPPOSITION

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CITATIONS

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OPINIONS BELOW

The opinion of the court of appeals is reported at 588 F. 2d 1358 (Pet. App. A1-A34). The opinion of the district court is reported at 450 F. Supp. 95 (Pet. App. B1-B3).

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. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether petitioner's purchase of securities based on material non-public information concerning forthcoming corporate acquisitions, obtained through his employment

in a financial printing firm, violated Section 10(b) of the Securities Exchange Act of 1934.

2. Whether Section 10(b) provided fair notice that petitioner's conduct was prohibited.

3. Whether the district court's instructions on intent were correct.

4. Whether the district court properly received in evidence an admission by petitioner that was privileged under state, but not federal, law.

STATUTE 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—
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> * * * * *
>
> (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.

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

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

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

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

STATEMENT

After 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 15 U.S.C. 78j(b), 17 C.F.R. 240.10b-5, and 18 U.S.C. 2. He received concurrent sentences of one year's imprisonment on the first 13 counts, of which all but one month was suspended. Sentences were also suspended on the last four counts, and petitioner was placed on five years' probation. The court of appeals affirmed (Pet. App. A1-A34).

The evidence at trial, which is summarized in the opinion of the court of appeals (Pet. App. A2-A5), showed that petitioner was an employee in a financial printing firm in New York City that specialized in printing prospectuses and other documents used in the securities industry. Because of the importance and confidentiality of the information contained in those documents and the statutory prohibition against misuse of that information, the printing firm gave express warning to its employees by signs placed throughout the establishment that such information was not to be used by any employee for private benefit, and that violation of this rule would subject the employee to immediate discharge and criminal penalties (Pet. App. A16-A17).

Between September 1975 and November 1976, petitioner's firm printed confidential documents relating to four tender offers and one merger. To preserve strict confidentiality, those documents were initially printed with the identities of the target corporations either omitted or expressed in code. In violation of the rules of his firm, petitioner used information contained in the draft offering documents (such as the market on which the stock was traded, the number of shares outstanding, the par value of the stock, and the high and low bids for the preceding year) to determine the identities of the five companies that were being acquired.[1] He then purchased stock in each corporation through seventeen separate transactions. After the merger and tender offers were publicly announced, the market price of the stocks increased substantially. In each instance, petitioner promptly sold the shares that he had purchased, making a profit totalling over $30,000.

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review by this Court is unwarranted.

1. Petitioner argues (Pet. 4) that his conviction was based on an unprecedented interpretation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. He further contends that liability has never before been imposed on anyone trading on the basis of material non-public information stemming from sources outside the corporation that issued the securities purchased or sold. That contention misconceives the purpose of the antifraud provisions in question and ignores prior precedent applying them in analogous situations.

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[1]This information was stipulated to be "material" in nature (Pet. App. A5 n.5).

A prime concern of Congress in enacting the Securities Exchange Act of 1934 was to preserve "fair and honest markets" essential to the confidence of public investors. See Section 2 of the Act, 15 U.S.C. 78b. See also *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 195 (1976); *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 11-12 (1971). To that end, Congress included the general antifraud provision of Section 10(b) as a "catch-all" to prohibit the use by any person of any manipulative or deceptive device or contrivance in connection with a purchase or sale of securities. This broad antifraud provision was intended " 'to deal with new manipulative [or cunning] devices' " injurious to the statutory goal of fair and honest trading (*Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 203 (brackets in original)), particularly those "practices which have been demonstrated to fulfill no useful function" (S. Rep. No. 792, 73d Cong., 2d Sess. 6 (1934)). As this Court has repeatedly noted, one of the fundamental purposes of Section 10(b) is to assure that "a high standard of business ethics [prevails] in the securities industry." *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972).[2]

Section 10(b) and Rule 10b-5 have long been interpreted to protect "the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information." *SEC* v. *Texas Gulf Sulphur Co.*, 401 F. 2d 833, 847-848 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). Accord, *SEC* v. *Shapiro*, 349 F. Supp.

[2]Congress reaffirmed these goals in 1975 when it adopted certain amendments to the Securities Exchange Act:

> 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.

H.R. Conf. Rep. No. 94-229, 94th Cong., 1st Sess. 91-92 (1975).

46, 52-53 (S.D.N.Y. 1972), aff'd, 494 F. 2d 1301 (2d Cir. 1974). The use of material non-public information, whether it is characterized as market information or corporate information, to obtain a trading advantage over other public investors is injurious to public confidence in the securities markets. This is especially true in the case of persons in the position of petitioner, since, as the court of appeals noted, "Chiarella had access on a regular basis to the most confidential information in the world of finance. Five times in less than fifteen months he obtained knowledge of facts that, when released, would have an immediate and dramatic effect 'on the Street' " (Pet. App. A7).

Because material information useful in securities trading generally stems from corporations that issue securities, most of the cases dealing with misuse of non-public information have involved inside corporate information. But even cases arising in that context have been careful to note that the rule against misuse of non-public information is not limited to such circumstances. Thus, in the seminal case of *In re Cady, Roberts & Co.*, 40 S.E.C 907 (1961), upon which petitioner relies, the Commission pointed out that "corporate insiders, e.g., officers, directors and controlling stockholders * * * do not exhaust the classes of persons upon whom there is such an obligation [to refrain from trading when in possession of material confidential information]." 40 S.E.C. at 912. The Commission there noted that the respondent had abused a confidential relationship by trading on inside information and had taken advantage of other persons participating in the market who lacked the benefit of such information. *Ibid.*

It is well settled that Section 10(b) and Rule 10b-5 are intended to protect public investors, and are not merely devices to safeguard the confidential relationship between insiders and issuer corporations. Thus, in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 150-154 (1972), this Court held that persons who profit by making a market in a security may not effect transactions on behalf of others without disclosing to them the facts relevant to market conditions. The defendants in *Ute*, like petitioner, misused non-public market information obtained by virtue of their relationship to the market for the securities in which they traded. The non-public information in *Ute* did not stem from a confidential corporate source, nor was it "inside" information in the traditional sense. This Court nonetheless held that Section 10(b) and Rule 10b-5 prohibited the defendants from exploiting their special knowledge of market conditions to the detriment of security sellers.[3]

Moreover, there is little difference between petitioner's conduct and that condemned in *SEC* v. *Capital Gains Research Bureau,* 375 U.S. 180 (1963), a case arising under Section 206 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-6), an antifraud provision containing prohibitions comparable to those of Rule 10b-5. In that case, an investment adviser purchased securities, made recommendations to his clients to purchase those same securities, and sold his shares thereafter when their market price had risen as a result of his recommendations. The defendant in *Capital Gains,* like petitioner, was trading on the basis of undisclosed market information, not information stemming from the corporation that issued the securities that he purchased. See also *SEC* v. *Shapiro,* 494 F. 2d 1301 (2d Cir. 1974), holding that Rule 10b-5 prohibits financial consultants from using non-public information concerning a merger plan of one corporation to purchase for themselves the securities of the other corporation involved in the merger. Petitioner's

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[3]See also *In re Blyth & Co., Inc. and Briggs,* [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 77,647 (SEC 1969).

position with respect to the company whose shares he purchased is not logically distinguishable from that of the financial consultants in *Shapiro.*[4]

Petitioner nonetheless contends (Pet. 9) that because parties seeking control of corporations may make limited purchases before disclosing their acquisition plans, he was also entitled to make purchases without infringing Section 10(b) and Rule 10b-5. However, acquiring parties are expressly permitted, pursuant to Section 13(d) of the Securities Exchange Act, 15 U.S.C. 78m(d), to purchase up to five percent of any class of equity securities of the acquired company without filing a disclosure statement. And Section 14(d) of the Act, 15 U.S.C. 78n(d), provides that a disclosure statement regarding a tender offer need not be filed until the offer is first published or sent to security holders. Those provisions reflect the congressional intent to strike a balance between the goals of full disclosure and the secrecy that must be maintained if legitimate corporate acquisitions are to take place. See generally H.R. Rep. No. 1711, 90th Cong., 2d Sess. 4 (1968). Thus, the statute explicitly allows potential tender offerors to "test the market" by confidentially acquiring limited quantities of the target company's stock.

This special rule, applicable to acquiring parties, has no relevance to petitioner's case. Petitioner was not engaged in the kind of legitimate economic activity that necessitates limited trading without disclosure of the trader's business plans. To the contrary, petitioner converted confidential information belonging to another

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[4]If petitioner were correct in contending that Section 10(b) prohibits misuse only of information stemming from issuer corporations, then it would follow that Section 10(b) permits officers and agents of acquiring firms to purchase the securities of target firms based on their knowledge of forthcoming mergers, acquisitions, and tender offers. That would clearly be contrary to the statutory purpose to preserve open and honest securities markets without preferences and advantages among investors.

party for the sole purpose of obtaining an advantage over uninformed sellers trading in the securities marketplace. As the court of appeals noted, "[i]t is difficult to imagine conduct less useful, or more destructive of public confidence in the integrity of our securities markets" (Pet. App. A15).

2. Petitioner also contends (Pet. 15-20) that his prosecution infringed the Due Process Clause because he had no fair warning that Section 10(b) and Rule 10b-5 would apply to his conduct. But all of the legal principles discussed immediately above were well established long before petitioner undertook his scheme to misuse non-public information. Moreover, those principles had been applied to misuse of tender offer information by employees of printing firms prior to the time of petitioner's purchases. See *SEC* v. *Sorg Printing Co.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 95,034 (S.D.N.Y. 1975). And, as noted by the court of appeals (Pet. App. A16-A17), petitioner received specific warnings from his employer that use of confidential information for securities trading would result in criminal penalties. The court below was therefore correct in concluding that petitioner "manifestly had adequate notice that his trading in target stock could subject him to criminal liability" (Pet. App. A15).[5]

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[5]Even if the prior proceeding in the *Sorg* case had not established that Rule 10b-5 applies to misuse of non-public information by print shop workers, that would not stand in the way of the present prosecution. Where a willful violation of the securities laws occurs, it is irrelevant that a case presenting precisely the same factual pattern has not arisen before. See *United States* v. *Brown*, 555 F. 2d 336, 339-340 (2d Cir. 1977) (the "fact that there is no prior litigated fact pattern precisely in point may constitute a tribute to the cupidity and ingenuity of the malefactors involved but hardly provides an escape from the penal sanctions of the securities fraud provisions here involved").

3. Petitioner also contends (Pet. 21-22) that the district court erred in refusing to instruct the jury that it must find a specific intent to defraud before convicting him.

But, as the court below noted, the district court instructed the jury that petitioner could not be convicted unless he acted "knowingly and willfully," 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" (Pet. App. A17-A18). Petitioner concedes that the court's instructions fully complied with the requirements of Section 32(a) of the Act, 15 U.S.C. 78ff(a), the general provision authorizing criminal prosecutions. See, *e.g.*, *United States* v. *Peltz*, 433 F. 2d 48, 53-54 (2d Cir. 1970), cert. denied, 401 U.S. 955 (1971). He asserts, however, that *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), invalidates the charge. But the holding in *Hochfelder* was that "§ 10(b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone" (*id.* at 201). In distinguishing between mere negligence and conduct involving some element of scienter, the Court obviously cannot be read as having suggested that knowing and willful misconduct is beyond the scope of the statute.

4. Finally, petitioner contends (Pet. 22-25) that the district court erred in allowing into evidence his admission to the New York State Department of Labor that he was fired for violating his company's rule prohibiting private use of confidential client information because such admissions are privileged under state law. As the court of appeals noted, however, even if the statement was privileged under state law, "[s]tate-created privileges are not controlling in federal criminal cases except to the extent they reflect 'the principles of the common law as they may be interpreted by the courts of the United States

in the light of reason and experience' " (Pet. App. A22-A23). That analysis complies fully with Fed. R. Evid. 501. See also *Funk* v. *United States*, 290 U.S. 371 (1933); *United States* v. *Allery*, 526 F. 2d 1362, 1364 (8th Cir. 1975). See generally, *United States* v. *Nixon*, 418 U.S. 683, 708-713 & n.18 (1974). Accordingly, the district court was not bound to recognize the New York privilege.

In any event, even if the admission of petitioner's statement was in error, any such error was clearly harmless. The evidence overwhelmingly established that petitioner was aware of his company's rule. As the court of appeals pointed out, signs warning petitioner of the company's rule were posted throughout the plant, and petitioner admitted passing those signs on hundreds of occasions. The district court concluded that his assertion that he had not read these signs was perjury "beyond a reasonable doubt" (Pet. App. A17 n.18). In light of the clear evidence of *mens rea*, the admission of cumulative evidence on this point could not have affected the result.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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