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SECURITIES REGULATION—THE DUTY TO DISCLOSE UNDER THE SECURITIES AND EXCHANGE COMMISSION'S SECTION 10(b) AND RULE 10b-5—*Moss v. Morgan Stanley, Inc.* 719 F.2d 5 (2d Cir. 1983)

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SECURITIES REGULATION—THE DUTY TO DISCLOSE UNDER THE SECURITIES AND EXCHANGE COMMISSION'S SECTION 10(b) AND RULE 10b-5—*Moss v. Morgan Stanley, Inc.*, 719 F.2d 5 (2d Cir. 1983).

I. INTRODUCTION

The stock market crash of 1929 and the depression of the 1930's prompted the enactment of statutory regulations designed to curtail abuse in the securities industry.¹ The drafters of the various statutes² hoped to achieve a "high standard of business ethics" and equality in the marketplace.³ The path to the seemingly idealistic target required the substitution of a standard of full disclosure in the securities marketplace for the time-honored standard of caveat emptor, or "let the buyer beware."⁴ In fact, courts and practitioners refer to this stricter standard when interpreting and applying securities law,⁵ thus spawning comment from legal authority aimed at analyzing the usefulness of the duty of disclosure in a practical setting.⁶

This note focuses on Section 10(b) of the Securities Exchange Act of 1934⁷ and Rule 10b-5⁸ promulgated under its authority. Specifically, this note examines the duty of disclosure as applied to those in

1. *S.E.C. v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963).

2. *Id.* (citing Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1982); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1982); Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-6 (1982); Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbbb (1982); Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (1982)).

3. *Id.* at 186; *see infra* note 5.

4. *S.E.C. v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963).

5. Rule 10b-5 "is 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." *S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968). "The maintenance of fair and honest markets in securities and the prevention of inequitable and unfair practices in such markets are primary objectives of the federal securities laws. Congress has recognized the essential importance of providing *full information* for both the buyer and seller." *In re Investors Management Co., Inc.*, 44 S.E.C. 633, 639 (1971) (emphasis added). One who has access to corporate information may not take "advantage of such information knowing it is unavailable to those with whom he is dealing." *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961).

6. One may best comprehend the duty of full disclosure by considering it a mechanism to prevent unjust enrichment, thereby encouraging equality in the marketplace. Langervoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CALIF. L. REV. 1, 2 (1982).

7. 15 U.S.C. § 78j (1982) provides in part:

possession of material⁹ nonpublic¹⁰ information, and the judicial application of the standard in *Moss v. Morgan Stanley, Inc.*¹¹

II. FACTS OF *MOSS*

In November of 1976, Warner-Lambert Company (Warner) retained the services of Morgan Stanley & Co., Incorporated (Morgan Stanley), an investment banking firm and subsidiary of Morgan Stanley, Inc. Warner was engaged in preliminary tender offer negotiations with Deseret Pharmaceutical Company (Deseret), and subsequently employed Morgan Stanley to aid in the evaluation of Deseret as the proposed target company.¹²

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.

Id.

8. 17 C.F.R. 240.10b-5 (1982) 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.

Id.

9. Materiality can best be understood in terms of the reasonable person standard. The proper inquiry is whether "there is a substantial likelihood that a reasonable [person] would consider [the information] important in deciding" the appropriate course of action. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). See also *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir. 1965) (A fact is material if a reasonable person would have "acted upon" it. *Id.* at 462). In addition, materiality in a non-disclosure action under Rule 10b-5 "encompasses those facts 'which in reasonable and objective contemplation might affect the value of the corporation's stock on securities.'" *Id.* (quoting *Kohler v. Kohler, Co.*, 319 F.2d 634, 642 (7th Cir. 1963)).

10. Information is nonpublic when it has not "been effectively disclosed in a manner sufficient to insure its availability to the investing public." *S.E.C. v. Texas Gulf Sulfur Co.*, 401 F.2d 833, 854 (2d Cir. 1968).

11. 719 F.2d 5 (2d Cir. 1983).

12. *Id.* at 8. Specifically, Warner hired Morgan Stanley to "assess the desirability of acquiring Deseret, to evaluate Deseret's stock and to recommend an appropriate price per share for the tender offer." *Id.*

At the time, Morgan Stanley employed E. Jacques Courtois, Jr., who, in that capacity, acquired information regarding the proposed Warner-Deseret tender offer.¹³ Courtois subsequently disclosed the information to Adrian Antoniu, an employee of Kuhn Loeb, Co.,¹⁴ and James M. Newman, a stockbroker.¹⁵ On November 30, 1976, Newman purchased Deseret stock at \$28 per share for himself, Courtois, and Antoniu.¹⁶ On the same day, Michael E. Moss sold 5,000 shares of Deseret stock at \$28 per share.¹⁷

The tender offer between Warner and Deseret was announced on December 7, 1976, with Warner offering \$38 per share for Deseret stock.¹⁸ Moss instituted an action for damages,¹⁹ alleging violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.²⁰ In his complaint, Moss alleged that individual defendants Courtois, Antoniu, and Newman had traded in Deseret stock with full knowledge of the impending tender offer and without disclosing the information to Deseret shareholders.²¹ In addition, Moss sought damages from Morgan Stanley under a "controlling person" theory, charging derivative liability for employee Courtois' wrongdoing.²²

The United States District Court for the Southern District of New York dismissed the action against all defendants.²³ The United

13. *Id.* Courtois worked in the mergers and acquisitions department at Morgan Stanley.

14. Kuhn Loeb, Inc. (presently known as Lehman Brothers Kuhn Loeb, Inc.) engages in investment banking. *United States v. Newman*, 664 F.2d 12, 15 (2d Cir. 1981).

15. *Moss*, 719 F.2d at 8.

16. *Id.* Two foreign citizens were also informed by Newman of the proposed merger. The three "conspirators," Newman and the two foreign nationals, purchased and sold stock on the basis of the information. All five participants then shared the profits. *United States v. Newman*, 664 F.2d 12, 15 (2d Cir. 1981). See *infra* notes 77-79 and accompanying text for a discussion of the criminal indictment of Newman.

17. *Moss*, 719 F.2d at 8.

18. *Id.*

19. *Id.* Moss commenced the action on behalf of himself and all others who had sold stock in Deseret on November 30, 1976.

20. *Id.*; see *supra* notes 7-8.

21. *Id.* at 8-9. The lower court dismissed the Section 10(b) claim against all defendants. Moss appealed only the dismissal of his claim against Newman. *Id.* at 9 n.2.

22. *Id.* at 9. "Controlling person" liability falls under Section 20(a) of the 1934 Act, 15 U.S.C. § 78t(a) (1976), which reads:

Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Id.

23. *Moss v. Morgan Stanley, Inc.*, 553 F. Supp. 1347 (S.D.N.Y. 1983).

States Court of Appeals for the Second Circuit affirmed,²⁴ holding in part that the plaintiff and the defendants lacked the insider or fiduciary relationship necessary to impose a duty of disclosure and possible liability for securities violations.²⁵

III. ROOTS OF THE DUTY OF DISCLOSURE

The law of insider trading²⁶ and the accompanying duty to disclose or abstain from trading on material nonpublic information is primarily associated with Section 10(b) and Rule 10b-5.²⁷ Since neither the Rule nor the provision specifically articulate the prohibition, the restraint upon trading results from judicial and administrative interpretation.²⁸

The Securities and Exchange Commission solidified the concept of the duty of disclosure in *In re Cady, Roberts & Co.*²⁹ The Commission imposed the obligation on corporate insiders, basing it first upon the existence of a relationship which affords access to corporate information, and second, upon the unfairness of allowing some individuals the advantage of the information while denying it to those with whom they deal.³⁰ The two-pronged theory evolved as the Commission interpreted the scope of the language "any person" as set forth in the rule and in the statutory provision.³¹ The Commission reached the conclusion that liability did not attach solely to traditional insiders,³² but could also be imposed upon anyone with access to corporate information who used it in transactions with someone not privy to it.³³

24. *Moss*, 719 F.2d at 8.

25. *Id.* at 13-14. The Court of Appeals affirmed the dismissal of the Section 20(a) claim, stating that since the claims against the individual defendants were dismissed, the claim of derivative liability must be as well. *Id.* at 17.

26. The traditional definition of an insider encompassed a corporate officer, a director, and a 10% beneficial owner. The definition derives primarily from Section 16 of the Securities and Exchange Act of 1934, which requires the disgorgement of profits by an officer, a director, or a 10% beneficial owner who engages in a sale and purchase or purchase and sale of corporate stock within 6 months. 15 U.S.C. § 78p (1982). Others may attain the status of corporate insider based solely on the existence of a special or fiduciary relationship. *Chiarella v. United States*, 445 U.S. 222 (1980). For a discussion of non-traditional insiders see *infra* notes 52-55 and accompanying text.

27. *Langevoort*, *supra* note 6, at 2.

28. *See supra* notes 7-8.

29. 40 S.E.C. 907 (1961) (involving violations of antifraud provisions of the securities acts by a partner in a broker-dealer firm who executed trading orders of the basis of non-public material information).

30. *Id.* at 912.

31. *Id.* *See supra* notes 7-8.

32. *See supra* note 26.

33. *Cady, Roberts*, 40 S.E.C. at 912. *See also* S.E.C. v. Texas Gulf Sulphur Co., 401

The ever-present goal of equality in the marketplace justified the theory of liability.³⁴ In an attempt to protect the unwary, the Commission broadly interpreted the scope of the protective securities laws, implying a duty owed to the general public.³⁵ The Commission limited itself significantly, however, by imposing the duty only upon those in a special relationship with a company: those who presumably had access to inside corporate information.³⁶

Later cases narrowed and defined the notion of a special or fiduciary relationship as a prerequisite to the duty to disclose.³⁷ In *Chiarella v. United States*,³⁸ the Supreme Court firmly established that liability for nondisclosure of material information could not be imposed absent the existence of "a relationship of trust and confidence" between parties to a transaction.³⁹ Furthermore, the Court stressed that mere trade upon material nonpublic information would not by itself impose

F.2d 833, 848 (2d Cir. 1968). The court held that Rule 10b-5 also applies to individuals possessing the information even though they "may not strictly be termed 'insider' within the meaning of Sec. 16(b) of the Act." *Id.* See *supra* note 26 for a discussion of Section 16(b).

34. See *supra* note 5.

35. *Cady, Roberts*, 40 S.E.C. at 913. The obligation of disclosure falls not only on existing shareholders, but extends as well to those who make sales of securities to non-shareholders. To hold otherwise would be to "ignore the plight of the buying public—wholly unprotected from the misuse of special information." *Id.* See *infra* notes 86-101 and accompanying text for a discussion of the misappropriation theory.

36. *Cady, Roberts*, 40 S.E.C. at 912. Again, the Commission was attempting to restrain individuals from capitalizing on an intimate position "lest the uninformed be exploited." *Id.*

37. See *Dirks v. S.E.C.*, 103 S. Ct. 3255 (1983). The *Dirks* Court described the disclosure duty as "extraordinary," stating that a duty will not attach absent "legal obligations other than a mere duty to comply with the general antifraud proscriptions in the federal securities laws." *Id.* at 3262-63. For a general discussion of arm's length transactions, see *Staffin v. Greenberg*, 672 F.2d 1196 (3rd Cir. 1982) ("one who purchases stock on the open market who is neither an insider nor a fiduciary, nor a 'tippee' of such a person, need not disclose the reasons for his purchase, even if the purchase is based on knowledge of material facts." *Id.* at 1202); *Polinsky v. MCA, Inc.*, 680 F.2d 1286 (9th Cir. 1982) (no duty to disclose could be imposed upon defendants, who purchased plaintiff's stock on the open market without disclosing their intent to make a later tender offer at a higher price; the parties in this transaction were market strangers, and, therefore, no fiduciary relationship existed); *Frigitemp Corp. v. Financial Dynamics Funds, Inc.*, 524 F.2d 275 (2d Cir. 1975) (an investment company's failure to disclose to the corporation, with which it was negotiating a debenture placement, that it already owned a substantial amount of that corporation's common stock, was not a breach of duty; defendants purchased on the open market, and such transactions did not impose a duty upon them).

38. 445 U.S. 222 (1980).

39. *Id.* at 228. The Court further held that the duty to disclose premised upon a special relationship was an established doctrine which should not be altered "absent some explicit evidence of congressional intent." *Id.* at 233.

liability.⁴⁰ A duty based upon a specific relationship between the parties must exist before liability will attach.⁴¹

The Supreme Court in *Chiarella* did not reach the issue of whether the misappropriation theory provided an alternative to the fiduciary requirement.⁴² Acceptance of the theory enlarges the class of potential defendants, and provides redress for injured plaintiffs who lack the special relationship established by *Cady, Roberts*.⁴³ Parenthetically, since the Court neither endorsed nor rejected the theory, speculation exists that it may provide an exception to the fiduciary requirement.⁴⁴

Chiarella established a standard to be met in cases dealing with Section 10(b) and Rule 10b-5. The court in *Moss*, following the *Chiarella* analysis, determined that the transactions between the individual defendants and the plaintiff shareholder were at arm's length.⁴⁵ The requisite fiduciary relationship being absent, the defendants were under no duty to disclose material information to the plaintiff. *Moss*, however, had advanced several alternate theories, described below, to support his claim that such a relationship existed.⁴⁶ The court rejected *Moss*' theories in an opinion consistent with existing law and established principles in the securities industry.⁴⁷

IV. THEORIES OF LIABILITY

A. *The Non-Traditional Insider Theories*

Imposing the duty to disclose upon traditional corporate insiders meets with little opposition.⁴⁸ Officers, directors and beneficial owners of the corporation are deemed fiduciaries of both the corporation and its shareholders because of their position with respect to the corporation.⁴⁹ The imposition of a duty to disclose or abstain from trading

40. "[A] duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information." *Id.* at 235.

41. *Id.* at 227-28.

42. 445 U.S. 222, 235-36.

43. See *supra* text accompanying note 30.

44. See *infra* notes 86-101 and accompanying text for a discussion of the misappropriation theory.

45. *Moss*, 719 F.2d at 13.

46. *Id.* at 13-14.

47. *Id.*

48. See *supra* note 26; see, e.g., *S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968). The defendants included corporate officers and directors who committed several securities violations. The court held that, as insiders, the defendants were "precluded by Rule 10b-5 from trading on material nonpublic information." *Id.* at 848.

49. *Dirks v. S.E.C.*, 103 S. Ct. 3255, 3261 (1983).

upon those fiduciaries is premised not only upon the theory of promoting equality in the marketplace,⁵⁰ but also upon the notion that fiduciaries should place the welfare of the shareholders and the corporation before their own.⁵¹

Since the definitional language is somewhat ambiguous, identifying non-traditional insiders continues to be a difficult task. Although they have "no special access to corporate information" in the sense that the traditional insiders do, they are charged with the duty of disclosure based upon the existence of a special relationship between themselves and the wronged individual or entity.⁵² The relationship may be direct, as in the case of a temporary insider who deals directly with a corporation and obtains confidential information in that capacity,⁵³ or it may be indirect, as in the case of a tippee⁵⁴ who becomes liable because the information obtained comes from a true corporate insider.⁵⁵

Moss presented several theories to establish a basis for the defendants' liability.⁵⁶ In one, Moss alleged that Morgan Stanley and Courtois had become insiders of Deseret because of their role in the tender offer negotiations.⁵⁷ Specifically, Moss alleged that as advisor to Warner, Morgan Stanley had obtained confidential information from Deseret,⁵⁸ the receipt of which transformed Morgan Stanley and its employee, Courtois, into insiders of Deseret.⁵⁹

50. *See supra* note 5.

51. At least one court has termed the duty to disclose or abstain as separate from the insider's general duties. According to this court, the insider's fiduciary relationship with the corporation and its shareholders creates the specific duty. *O'Connor & Associates v. Dean Witter Reynolds, Inc.*, 529 F. Supp. 1179, 1187 (S.D.N.Y. 1981).

52. *Moss*, 719 F.2d at 11.

53. "[A]n underwriter, accountant, lawyer or consultant working for the corporation" may obtain access to confidential information, thereby becoming a temporary insider because of the position. *Dirks v. S.E.C.*, 103 S. Ct. 3255, 3261 n.14 (1983). *See also* *S.E.C. v. Lund*, 570 F. Supp. 1397 (C.D. Cal. 1983). A temporary insider "assume[s] the duties of an insider temporarily, by virtue of a special relationship with the corporation," and acquires the same disclosure and abstention requirements. *Id.* at 1403.

54. A tippee is one who "knowingly receives material nonpublic information from an insider and trades on it." *Dirks v. S.E.C.*, 103 S. Ct. 3255, 3263 (1983). Tippees acquire liability because they assume a fiduciary duty "only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach." *Id.* at 3264.

55. A true (or traditional) corporate insider is a corporate officer, a director, or a beneficial owner. *See supra* note 26.

56. *Moss*, 719 F.2d at 13-16.

57. *Id.* at 13-14.

58. *Id.* at 13.

59. *Id.* In essence, Moss' argument for imposing the duty requirement upon Newman paralleled the argument for its imposition on Courtois. Specifically, Moss' argument

The court rejected the argument,⁶⁰ stating that Morgan Stanley's employment by one party to a tender offer did not, by itself, accord the corporation insider status with regard to the other party. Morgan Stanley's client was Warner, and therefore any duties and obligations were owed to Warner and its shareholders, not to Deseret.⁶¹

In *Moss*, the court relied upon the case of *Walton v. Morgan Stanley & Co., Inc.*,⁶² which had a factual situation similar to *Moss*. In *Walton* the court held that although the target company may have placed confidence in the investment company not to disclose information of the impending tender offer, the investment company was under no duty to preserve the confidence.⁶³ The investment company's obligations lay with its clients, the acquiring company and its shareholders. Similar to the parties in *Walton*, Morgan Stanley and Deseret were "at all times responsible to different interests."⁶⁴

Morgan Stanley and Deseret dealt at arm's length with each other. A fiduciary duty does not attach in transactions between market strangers.⁶⁵ Moss acted as an open market trader when he sold his shares of Deseret stock. One dealing with the impersonal securities marketplace is subject to inherent risks, including the likelihood that shares sold one day may be worth more the next.

In the second theory, Moss argued to impose a duty to disclose on

was that if Courtois were considered an insider of Deseret by virtue of his employment with Morgan Stanley, then Newman should be subject to the same duty to disclose and be liable for nondisclosure upon the theory of tippee liability. *Id.* at 13-14. *See supra* note 55.

60. *Moss*, 719 F.2d at 13.

61. The court in *Dirks v. S.E.C.*, 103 S.Ct. 3255 (1983), noted that in certain situations, "as where corporate information is revealed legitimately to an underwriter, accountant, lawyer or consultant *working for the corporation*" a fiduciary relationship may develop between those individuals and the shareholders. *Id.* at 3261 n.14 (emphasis added). The opinion further stipulated that in order for duties to legitimately attach, the corporation "must expect the outsider to keep the disclosed nonpublic information confidential and the relationship at least must imply such a duty." *Id.* It bears reemphasis that in the present situation Warner employs Morgan Stanley and presumably expects confidential information to remain confidential. Deseret and its shareholder Moss represent the target company and do not enjoy the legitimate expectations of a fiduciary duty.

62. 623 F.2d 796 (2d Cir. 1980) (involving a shareholder's derivative action brought by target company shareholders (Olinkraft); the claim was that Morgan Stanley, as employed by Kennecott (the acquiring company), breached a fiduciary duty owed to Olinkraft shareholders when it disclosed confidential information to Morgan Stanley during tender offer negotiations).

63. *Id.* at 799.

64. *Id.* at 798.

65. *See supra* note 37 for a discussion of arm's length transactions. *See also* General Time Corporation v. Talley Industries, Inc., 403 F.2d 159 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969) (defendant purchasers, affiliates of a corporation intending a merger with plaintiff, held not to be fiduciaries and thus not liable for failure to disclose affiliate status).

Newman based upon a broker-dealer theory of liability.⁶⁶ Moss alleged that Newman, in his capacity as a stockbroker, "owed a general duty to the market to disclose material nonpublic information prior to trading."⁶⁷ The court rejected the argument as inconsistent with applicable law.⁶⁸ Despite the fact that equality in the marketplace and protection of the uninformed lie at the heart of the securities laws,⁶⁹ a generalized duty owed to the public at large cannot prevail. Imposition of a generalized duty "departs radically from the established doctrine that duty arises from a specific relationship between two parties"⁷⁰ and hampers the profitmaking nature of the securities marketplace.⁷¹ Congress and the Commission have already addressed "by detailed and sophisticated regulation"⁷² instances in which the use of market information may be harmful to the effective "operation of the securities market,"⁷³ thereby providing adequate protection for the public. As evidenced in *Cady, Roberts*⁷⁴ and *Chiarella*⁷⁵ a fiduciary relationship must exist before a duty of disclosure may be imposed.⁷⁶ Had Moss been a client of Newman's,⁷⁷ or had an insider to Moss or Deseret disclosed the information,⁷⁸ a fiduciary relationship would

66. *Moss*, 719 F.2d at 14-15.

67. *Id.* at 14.

68. *Id.* at 14-15.

69. *See supra* note 5.

70. *Chiarella v. United States*, 445 U.S. 222, 233 (1980). *See supra* notes 37-41 and accompanying text.

71. *See General Time Corporation v. Talley Industries, Inc.*, 403 F.2d 159 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969) ("We know of no rule of law . . . that a purchaser of stock, who was not an 'insider' and had no fiduciary relation to a prospective seller, had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale." *Id.* at 164). As the *Moss* court stated, imposing a duty of disclosure on broker-dealers "could have an inhibiting influence on the role of market analysts, which the SEC recognized is necessary to the preservation of a healthy market." *Moss*, 719 F.2d at 15 (quoting *Dirks v. S.E.C.*, 103 S. Ct. 3255, 3263 n.17 (1983)).

72. *Chiarella v. United States*, 445 U.S. 222, 233 (1980).

73. *Id.*

74. 40 S.E.C. 907 (1961). *See supra* notes 29-36 and accompanying text.

75. 445 U.S. 222 (1980). *See supra* notes 38-47 and accompanying text.

76. In the case of a tippee there must be a breach of a fiduciary duty before liability will attach. *See supra* note 54.

77. *See Lewelling v. First California Co.*, 564 F.2d 1277 (9th Cir. 1977) (an investment company employee had a duty to disclose material information to his client); *In re Merrill, Lynch, Pierce, Fenner, and Smith*, 43 S.E.C. 933, 937 (1969). In *Merrill, Lynch* a broker-dealer company and certain of its employees disclosed material information to select customers; the Commission noted the "inherent unfairness of disclosure to certain customers." *Id.* The broker-dealer owed a duty of disclosure to all its customers, and the Commission condemned the selective disclosure. Liability, however, flowed from the finding that the information itself should not have been disclosed to anyone but should have been held in the strictest confidence. *Id.*

78. *See supra* note 54 for a discussion of tippee liability. *See also Newman*, 664 F.2d

have existed.⁷⁹

Moss advanced a third theory, in which he argued that a duty existed based upon *United States v. Newman*.⁸⁰ He asserted that since the *Newman* court determined that Courtois and Newman owed a duty to Morgan Stanley, Kuhn Loeb, and their respective clients, the duty should extend as well to Deseret and its shareholders as the target corporation.⁸¹

In rejecting Moss' third argument, the court stated that the holding in *Newman* was "explicitly limited"⁸² to "the allegations of the indictment, which allege essentially that the defendants defrauded the investment banking firms and the firms' takeover clients."⁸³ The court, therefore, could not entertain allegations that target company shareholders had been defrauded. Moreover, the court emphasized that nothing in the *Newman* opinion might stretch "an employee's duty to 'abstain or disclose' with respect to his employer . . . to encompass an employee's 'duty of disclosure' to the general public."⁸⁴ Moss' argument merely attempted to "piggyback" on the *Newman* allegations and convictions, and, therefore, lacked any independent legal justification.⁸⁵

12 (1983) (*Newman* was held criminally liable for trading upon information he had received from corporate insiders of Morgan Stanley). See *infra* notes 80-84 and accompanying text for a discussion of Newman's criminal conviction.

79. See *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 154 (1972) (bank employees breached a disclosure duty to the plaintiff corporation; in assuming its duties as a transfer agent, the bank also assumed accompanying obligations, including the duty of disclosure).

80. 664 F.2d 12 (2d Cir. 1981). The court held defendants had sullied the reputations of Morgan Stanley and Kuhn Loeb, sufficing to establish the requisite duty for a Section 10(b) violation. *Id.* at 17. The court imposed a duty even though neither Morgan Stanley nor Kuhn Loeb "was at the time a purchaser or seller of the target company securities in any transaction with any of the defendants." *Id.* at 16. The court elaborated "the courts, not the Congress, have limited Rule 10b-5 suits for damages to the purchasers and sellers of securities." *Id.* at 17. Since this was not a civil suit for damages, the court did not impose the requirement but instead emphasized that the remedial purposes of the securities laws could best be served by imposing criminal sanctions upon the defendants in this situation. *Id.* at 16-17.

81. *Moss*, 719 F.2d at 13.

82. *Id.*

83. *Id.* (quoting *United States v. Newman*, 664 F.2d 12, 15 n.1 (2d Cir. 1981)).

84. *Id.* at 13.

85. *Id.* In essence, Moss argued that Newman owed him the duty of disclosure because Newman owed the duty to Morgan Stanley and its client Warner. Moss relied on no discrete argument but simply "piggy back[ed] upon the duty owed by defendants to Morgan Stanley and Warner." *Id.* (quoting *Moss v. Morgan Stanley, Inc.*, 553 F. Supp. 1347, 1353 (S.D.N.Y. 1983)).

B. *The Misappropriation Theory*

Moss' final effort to establish a basis for recovery rested on the misappropriation theory which the Supreme Court had not reached in *Chiarella*.⁸⁶ Under the theory, liability would attach to any person who traded on the basis of nonpublic misappropriated information; that is, information improperly obtained or converted to personal use.⁸⁷ In *Chiarella* the government argued an alternative theory of liability based on the misappropriation theory. The government proposed that the defendant had breached a duty to the acquiring company, his employer's client, when he had misappropriated the information about the tender offer from his employer.⁸⁸ Since the trial judge had not instructed the jury on the theory, the Court could not accept it as a basis for affirming *Chiarella*'s criminal conviction.⁸⁹ The Supreme Court refused to "speculate upon whether such a duty exists, whether it has been breached, or whether such a breach constituted a violation of § 10(b)." ⁹⁰

The Court in *Chiarella*, then, deferred the issue of whether liability can be imposed for trading on the basis of nonpublic misappropriated information.⁹¹ The Court of Appeals for the Second Circuit has addressed the question, however, in both *Newman*⁹² and *Moss*.⁹³ In

86. 445 U.S. 222. The Supreme Court held in *Chiarella* that *Chiarella* did not have a fiduciary relationship with respect to the sellers of stock, and therefore did not owe them a duty of disclosure. "No duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He 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." *Id.* at 232-33. See *supra* notes 38-44 and accompanying text.

87. *Chiarella*, 445 U.S. at 239 (Brennan, J., concurring). "A person violates § 10(b) whenever he improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities." *Id.*

88. *Id.* at 235-36.

89. "The jury instructions demonstrate that petitioner was convicted merely because of his failure to disclose material, nonpublic information to sellers from whom he bought the stock of target corporations. The jury was not instructed on the nature or elements of a duty owed by petitioner to anyone other than the sellers." *Id.* at 236.

90. *Id.* at 236-37.

91. Chief Justice Burger in his dissenting opinion in *Chiarella* states that "[t]he Court's opinion, as I read it, leaves open the question whether § 10(b) and Rule 10b-5 prohibit trading on misappropriated nonpublic information." *Id.* at 243 (Burger, C.J., dissenting).

92. 664 F.2d 12 (2d Cir. 1981). A recent law journal note stated that although the court in *Newman* reached a correct conclusion, the path to that result was misguided. The author argued that *Newman* owed a duty to the public at large and not just to those buyers and sellers with whom he had a special relationship. "Rule 10b-5 criminal liability should attach whenever a person trades on nonpublic information obtained by reason of a special

Newman, the court imposed criminal liability in a misappropriation situation,⁹⁴ but in *Moss* the court did not impose civil liability in the identical situation.⁹⁵

The logical inquiry follows: How can there fail to be civil liability for an action for which criminal liability exists? Causation and standing provide the basis for the distinctive treatment. Although *Newman* profited and *Moss* suffered by their respective transactions on November 30th, nothing indicated that *Newman*'s purchases on that day provided the incentive for *Moss*' decision to sell.⁹⁶ Quite probably, *Moss* would have sold his shares anyway, and, therefore, no conclusive proof exists that *Newman*'s actions legally caused *Moss*' loss.

No question exists that *Newman* did profit from his market transactions. The victim of his fraudulent schemes was not *Moss*, however, but the entire securities marketplace, which inevitably suffers from schemes perpetrated by persons such as *Newman*. A generalized harm does not afford *Moss*, in his position as an individual trader, standing to bring suit.⁹⁷

Standing and causation, therefore, do provide a rational basis for distinguishing between the applicability of criminal and civil liability in the same situation. Under a policy analysis, however, the distinc-

relationship to any entity, regardless of the nonexistence of a common-law fiduciary duty, which results in that person having access to information unavailable to the general public. Only then will public confidence in the securities market be maintained." Note, *Retributive or Remedial: What is the Objective of Imposing Criminal Sanction in Section 10(b) Actions Under the 1934 Securities Exchange Act?*, J. CORP. L. 527, 541 (1983).

93. 719 F.2d 5 (2d Cir. 1983).

94. The court stated that *Newman* "misappropriated—stole to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence." 664 F.2d 12, 17 (quoting *United States v. Chiarella*, 445 U.S. 222, 245 (Burger, C.J., dissenting)). The court concluded, moreover, that *Newman* and his "cohorts" had defrauded the investment companies just as "surely as if they took their money." *Id.*

95. The *Moss* court felt that the effect of *Moss*' misappropriation argument would be to "grant . . . [*Moss*] a windfall recovery simply to discourage tortious conduct by securities purchasers," a result which the court felt was not intended by the securities' provisions. 719 F.2d 5, 16. The court reiterated its interpretation of a Supreme Court mandate to refuse to recognize the imposition of a generalized duty, a duty owed to "all participants in market transactions to forgo actions based on material, nonpublic information." *Id.* (quoting *Chiarella v. United States*, 445 U.S. 222, 233 (1980)).

96. A perusal of the facts presented in *Moss* fails to provide any indication that *Moss*' decision to trade resulted from *Newman*'s actions. In fact, *Moss*' 5,000 shares represented only a portion of some 143,000 *Deseret* shares that changed hands on that day. 719 F.2d 5, 8.

97. In *United States v. Richardson*, 418 U.S. 166 (1974) and *Schlesinger v. Reservists Committee to Stop the War*, 418 U.S. 208 (1974), the Supreme Court firmly established that ". . . a direct injury, and not merely a general interest common to all members of the public, is required for standing." C. Wright, *LAW OF FEDERAL COURTS*, § 13,67 (1983).

tion pales. The possibility of recovery would give civil plaintiffs an incentive to uncover frauds which the Commission might fail to detect. Since defendants' liability would be limited to the amount of profit on the transaction, questions of unfairness would not arise.⁹⁸ Civil liability, then, would seem to aid, rather than hinder, the ultimate goals of equality of the marketplace by providing an additional check on securities violations without raising questions of unfairness.⁹⁹

The language found in Section 10(b) and Rule 10b-5, specifically the phrase "any person,"¹⁰⁰ provides not only for the formulation of the misappropriation theory, but arguably also provides for its inapplicability in *Moss*. A close reading of *Cady, Roberts*¹⁰¹ and the majority opinion in *Chiarella*¹⁰² contradicts Chief Justice Burger's interpretation of the phrase. The Commission itself focused on the phrase and

98. "The measure of damages in the case of a defrauded seller is . . . the difference between the fair value of all that the seller received and the fair value of what he would have received had there been no fraudulent conduct. . . . Generally, any subsequent profits realized by a defrauder through resale of the securities which he has purchased must be restored to the seller under a theory of constructive trust, provided that such subsequent profits do not result from the defrauding buyer's own efforts which have given the securities an increased value subsequent to the purchase." W. Cary & M. Eisenberg, *CORPORATIONS* 792 (5th ed.—unabr. 1980).

99. Section 14(e), 15 U.S.C. § 78n(e) (1982) and Rule 14e-3, 17 C.F.R. § 240.14e-3 (1984), allow for the imposition of civil liability against persons who trade on the basis of material nonpublic information relating to a tender offer. *Moss* brought a Section 14(e) and Rule 14e-3 claim, which the district court dismissed since the "actions involved in [the] litigation took place before the adoption of the Rule." *Moss v. Morgan Stanley, Inc.*, 553 F. Supp. 1347, 1355 (S.D.N.Y. 1983). The court held that the Commission, in adopting the rule considered it prospective in effect, and the rule thus, "should not be given retroactive effect." *Id.* at 1356.

Had rule 14e-3 been in force during the time in question, it would have allowed for a claim of civil liability against the defendants. It seems apparent that the Commission in enacting the rule attempted to rid the industry of the obvious discrepancies between the imposition of civil and criminal liability in the same situation. The rule, however, does not cover all situations in which there may be trading on material nonpublic information. For example, news of rich mineral deposits in land owned by a corporation clearly would have a positive effect on the value of the company's stock. A person purchasing stock utilizing the material nonpublic information, although acting in a deceptive manner, would not be susceptible to the sanctions of civil liability under Section 14(e), or perhaps under Section 10(b), unless the requisite fiduciary relationship were present. *See S.E.C. v. Texas Gulf Sulfur Co.*, 401 F.2d 833 (2d Cir. 1968). Again, in the above situation, as in *Moss*, persons harmed by fraudulent schemes are allowed no compensation, except for the non-monetary satisfactions that imposition of criminal sanctions on the defendants might bring. Clearly, the Commission through Section 14(e) and Rule 14e-3 is reaching the majority of harmed securities plaintiffs and providing relief. These regulations, then, indicate a positive policy decision on the part of the Commission to eliminate the seemingly irrational situations that allow for the imposition of criminal liability but deny civil liability.

100. *See supra* notes 7-8.

101. 40 S.E.C. 907 (1961).

102. 445 U.S. 222 (1980).

concluded that Section 10(b) and Rule 10b-5 liability applied only when a person had access to corporate information intended to be used only for corporate purposes, and where the use of the information would be inherently unfair to those ignorant of its existence.¹⁰³ Courts should defer to the Commission's conclusion since the agency was interpreting its own regulation.¹⁰⁴

V. CONCLUSION

Section 10(b) and Rule 10b-5 premise liability on certain securities market traders based upon a duty to disclose. The duty attaches to parties who have a special or fiduciary relationship with one another.¹⁰⁵ The existence of a fiduciary relationship does not require a traditional insider, but may develop as well in non-traditional insiders as a result of business associations or special confidences. Trust and confidence between parties to a transaction are controlling factors in determining the existence of such a relationship.¹⁰⁶ The requirement of a fiduciary relationship prior to the imposition of liability encourages a high standard of ethical conduct in the securities industry. Individuals are compelled to recognize and respect those persons whose trust and confidence they retain.

None of the defendants in *Moss* owed a duty of disclosure to the plaintiff. Moss traded in the open market, voluntarily submitting himself to the risks inherent in the marketplace. Certainly the actions of defendants Courtois, Antoniu and Newman should be condemned. They must answer to Morgan Stanley and Kuhn Loeb, however, since the relationships there involved were based upon trust. As the court in *Moss* emphasized, the requirement of a fiduciary relationship before the imposition of liability is endorsed not only by the Commission, but by the Supreme Court as well. Speculation that the misappropriation theory provides an alternative to the fiduciary requirement is still without merit, since although the Supreme Court did not condemn the theory's applicability, neither did it endorse it. Prudence suggests that this established doctrine, that there must be a fiduciary relationship before liability will be imposed, should not be altered "absent some explicit evidence of congressional intent."¹⁰⁷

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103. *Cady, Roberts*, 40 S.E.C. at 912.

104. *Dirks v. S.E.C.*, 681 F.2d 824, 839 (D.C.Cir. 1982).

105. See *supra* notes 29-44 and accompanying text.

106. See *supra* note 39 and accompanying text.

107. *Chiarella*, 445 U.S. at 233.