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ANOTHER DAY COMES—MISAPPROPRIATION AS AN ALTERNATE BASIS FOR SECTION 10(b) LIABILITY

Securities Exchange Commission v. Materia
745 F.2d 197 (2nd Cir. 1984),
cert. denied, 105 S. Ct. 2112 (1985)

HAL MORRIS*

I. INTRODUCTION

Fraud in the financial markets is not a uniquely contemporary problem. However, a recent rash of highly visible and allegedly fraudulent transactions based on material, non-public information, have served to capture and focus the attention of the Securities Exchange Commission (S.E.C.) on this problem. Basing its activities primarily upon the Securities Exchange Act of 1934, the S.E.C. is utilizing the broad anti-fraud provisions of Section 10(b) and Rule 10b-5 promulgated thereunder to


3. See infra note 7.


   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 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.

6. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1984), 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 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 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.
combat the trading of securities based on material non-public information. Though the magnitude of trading of this type is impossible to determine, the S.E.C. is undertaking a vigorous enforcement program against what it believes to be a serious problem.\footnote{7}

Until recently, if the S.E.C. hoped to be successful in prosecuting this type of enforcement action, it had to meet the stringently applied elements of a Section 10(b) action.\footnote{8} Traditionally, the courts required proof of a special relationship affording access to confidential non-public information before they would place sanctions on persons engaging in this type of trading.\footnote{9} However, in several recent cases, the S.E.C. has successfully brought enforcement actions based upon an alternate theory of fraud, which does not require a showing of a special relationship as a condition precedent to liability.\footnote{10} These so-called “outsider trading” cases are founded on the theory of “misappropriation.”\footnote{11} This article seeks to explore, in the context of the Second Circuit case of \textit{S.E.C. v. Materia},\footnote{12} this novel and emerging theory of securities fraud. In the context of this article, the roots of this theory are explored. In addition, because the Supreme Court has yet to grant \textit{certiorari} to a misappropriation case,\footnote{13} this article endeavors to predict the possible outcome of any eventual Supreme Court review.

\footnote{7}{John M. Fedders, director SEC Enforcement Division, noted in Remarks To Fall Meeting of the Association of General Counsel (Washington, D.C. October 8, 1981), that:

The Commission remains deeply concerned about trading by persons in possession of material non-public information. The Commission has brought over 40 cases in this area since January 1978. This is more insider trading cases than it brought from 1934 to 1978. Yet, more can and will be done in this area.

[There remains widespread abuse of material non-public information . . . We will not shy away from cases based on circumstantial evidence if the relevant facts demonstrate that any person breached a trust, confidence or other duty owed to another person by effecting trades while in possession of inside information.

Quoted in Fourteenth Annual Institute on Securities Regulation, vol. 2, 373 (1982).}

\footnote{8}{\textit{E.g.}, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976) \textit{reh. denied} 425 U.S. 986 (1976) (Proof of Scienter); Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2nd Cir. 1952), \textit{cert. denied}, 343 U.S. 956 (1952) (In connection with a purchase or sale of security); \textit{see generally} 5 Jacobs, \textit{Litigation and Practice Under Rule 10b-5} §§ 36-38 (1984) for a discussion of the elements of a Section 10(b) action.}

\footnote{9}{\textit{See In re Cady}, Roberts & Co., 40 S.E.C. 907 (1961); \textit{see also infra} notes 25-30 and accompanying text.}


\footnote{11}{Koeltl & Kubek, \textit{Chiarella and Market Information}, \textit{REV. OF SEC. REG.}, June 18, 1980 (Discusses liability of non-insiders.).}

\footnote{12}{745 F.2d 197 (1984), \textit{cert. denied}, 105 S. Ct. 2112 (1985).}

\footnote{13}{\textit{In Chiarella v. United States}, 445 U.S. 222 (1980), the Court never reached the merits of the issue of misappropriation because it was not submitted to the jury by the trial court. \textit{In United States v. Newman}, 664 F.2d 12 (2nd Cir. 1981), \textit{aff’d after remand}, 722 F.2d 729 (2nd Cir. 1983), \textit{certiorari} was denied. \textit{See supra} note 10.}
II. BACKGROUND FROM 1934 TO CADY, ROBERTS

Both the Securities Act of 193314 and the Securities Exchange Act of 193415 were enacted in the wake of the Great Depression. The nation's financial markets were still reeling from the stock market crash of 1929.16 The foremost purpose of these two monumental pieces of New Deal legislation was to restore lost investor confidence in the depression ravaged financial markets and foster capital formation.17 As a part of these Acts, and in support of their purpose, Congress provided a plethora of civil and criminal liabilities.18

Of particular importance are the liabilities included in Section 10(b) of the 1934 Act.19 This section and Rule 10b-5,20 which the S.E.C. promulgated thereunder,21 are the primary anti-fraud provisions of the 1934 Act. These anti-fraud provisions are the cornerstones of the S.E.C.'s enforcement program to combat fraudulent trading.22 Though the courts have traditionally applied these provisions very broadly,23 so as to achieve an overall remedial purpose to the securities laws,24 it was not until the S.E.C.'s administrative decision of In re Cady, Roberts & Co.25 that a general "abstain from trading or disclose" rule was expressly applied to non-corporate insiders.

In Cady, Roberts, the S.E.C. found a broker liable under Section 10(b) for trades he made based on material non-public information acquired from a corporate director. The S.E.C. found that the broker had a duty to either abstain from trading on such information or to disclose the

17. See S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933); H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933). Accord President Roosevelt's Message to Congress, of March 29, 1933, in which he stated that the 1933 Act "adds to the ancient rule of caveat emptor the further doctrine 'let the seller also beware.' " H.R. REP. No. 85, 73d Cong., 1st Sess. 2 (1933).
19. See supra note 5.
20. See supra note 6.
21. Pursuant to 15 U.S.C. § 78w(a)(1) (1982) the S.E.C. is specifically given the "power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this chapter. . . ."
information. This duty, the S.E.C. reasoned, was based on two factors: 1) "the inherent unfairness involved where a party takes advantage of such information;" and 2) "the existence of a relationship giving access, directly or indirectly to information intended to be available only for a corporate purpose and not for the personal benefit of anyone." This duty, to abstain or disclose, was a correlative duty based upon the existence of a special relationship. It was this special relationship that resulted in the trading broker's vicarious liability under Section 10(b).

In support of its decision to find liability, the S.E.C. noted, that "[a] significant purpose of the Exchange Act was to eliminate the idea that the use of inside information for personal advantage was a normal emolument of corporate office."

After Cady, Roberts, the Second Circuit gave judicial recognition to the Cady, Roberts' reasoning in the case of S.E.C. v. Texas Gulf Sulphur. In Texas Gulf Sulphur, several officers and employees purchased stock of that company without disclosing their knowledge of material non-public information regarding recent mineral finds. The Second Circuit found these officers and employees guilty under Section 10(b). However, the court focused its attention primarily on the fairness element of the Cady, Roberts test. In its now famous dicta, the court created an expanded interpretation of Cady, Roberts when it stated that "anyone in possession of material inside information . . . must either disclose it to the investing public or . . . abstain from trading." Based on this reasoning, Texas Gulf Sulphur's dicta indicated that any trading based on material non-public information would be fraudulent. Under the reasoning of Texas Gulf Sulphur, mere possession of material non-public information, even absent a special relationship, would trigger the Cady, Roberts "abstain or disclose rule." Application of this broadened "abstain or disclose rule" has been invoked in numerous situations, including cases against underwriters, attorneys, accountants, and

26. Id. at 912.
27. Id.
28. Id.
29. The S.E.C. noted that the issue in Cady, Roberts was "to identify those persons who are in a special relationship with a company and privy to its internal affairs and thereby suffer correlative duties in trading in its securities." Id.
30. Id. at 912, n.15.
32. Id. at 864.
33. Id. at 848.
34. Id.
Even after the decisions in *Cady, Roberts* and *Texas Gulf*, there was a marked reluctance by the courts to apply the broadened abstain or disclose rule to non-insiders. However, *Chiarella v. United States*, a criminal securities fraud case, attempted to change this judicial reluctance. The defendant in *Chiarella* was a mark-up man who worked for a financial printer. As a part of his job, Chiarella proofread documents used for tender offers. Though his employer attempted to conceal the names and identities of the companies involved, Chiarella was able to discern the identities of five takeover targets. On the basis of this information, and without disclosing this information, Chiarella purchased on the open market stock of each of these target companies. He then sold these shares, at a substantial profit, immediately after public announcements of the tender offers were made. Based on these activities, the government brought suit against Chiarella alleging criminal violations of Section 10(b) and Rule 10b-5.40

At trial, Chiarella was convicted. The Second Circuit upheld the conviction, holding that "[a]nyone—corporate insider or not—who regularly receives material non-public information may not use that information to trade in securities without incurring an affirmative duty to disclose."42 In essence, the Second Circuit reiterated its support for *Texas Gulf* by noting that Section 10(b) and Rule 10b-5 required equal access to information before one can trade on such information.43

However, Chiarella's conviction was reversed by the Supreme Court.44 Justice Powell, writing for the majority, began the Court's analysis with a discussion of *Cady, Roberts*. Justice Powell explicitly upheld the *Cady, Roberts* decision when he stated that a failure to disclose non-public information is only actionable under Section 10(b) when one has a duty to disclose and breaches that duty.45

Moreover, according to the Court, this duty to disclose only arises

40. Mr. Chiarella was named, during January of 1978, in a 17 count indictment alleging criminal violations of Section 10(b) and Rule 10b-5. Id. at 225.
42. U.S. v. Chiarella, 588 F.2d 1358, 1365 (2nd Cir. 1978) (emphasis in original).
43. Id. at 1362.
44. 445 U.S. 222 (1980).
45. Id. at 229-30.
when a special relationship of trust and confidence exists. The Court concluded that no duty arose from Chiarella's relationship with the sellers. Through this holding, the Court rejected the Second Circuit's equal access test. In rejecting that test, the Court commented that not every unfair transaction gives rise to liability under Section 10(b). Furthermore, Chiarella's failure to disclose was not fraudulent because he had no duty to speak. Justice Powell concluded the majority opinion by rejecting the Second Circuit's dicta in *Texas Gulf* when he stated that: "When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. Therefore we hold that a duty to disclose under Section 10(b) does not arise from the mere possession of nonpublic market information." Through this holding, the Court clearly rejected a rule of liability based on parity of information.

The government, however, on appeal offered an alternate theory under which Chiarella's conviction could be affirmed. The government argued that Chiarella breached a duty to the acquiring corporations when he bought and sold securities based on information obtained by virtue of his position with a printer hired by those corporations. However, the Court never reached the merits of this argument because it stated that it "cannot affirm a criminal conviction on the basis of a theory not presented to the jury." The court refused to speculate as to the efficacy of this alternate theory. Accordingly, Justice Stevens, in his concurring opinion, commented that "the Court wisely leaves the resolution of this issue for another day."

Chief Justice Burger, in a strongly worded dissenting opinion, argued that the strict requirements of a fiduciary or special relationship "should give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful

46. Id. at 230. Justice Powell stated that "liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." Id.
47. *See S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d at 848.
48. 445 U.S. at 232. The court observed that "not every instance of financial unfairness constitutes fraudulent activity under § 10(b)."
49. The Court noted that:
   the element required to make silence fraudulent—a duty to disclose—is absent in this case.
   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 with 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.
50. Id. at 235.
51. Respondent's Brief at 16, *Chiarella*.
52. 445 U.S. at 235.
53. Id. at 236 (emphasis added).
54. Id. at 238 (Stevens, J. concurring).
Relying on the tort duty to disclose illegally acquired information, the Chief Justice reasoned that a person who misappropriated material, non-public information, has an absolute duty to abstain or disclose, even in the absence of a special relationship.\(^5\) The Chief Justice concluded that Chiarella "misappropriated—stole to put it bluntly... [and] then exploited his ill-gotten informational advantage by purchasing securities in the market."\(^5\)

Scarcely seven months passed when the Chief Justice's reasoning in *Chiarella* was adopted by the Second Circuit. In *United States v. Newman*,\(^5\) the Second Circuit reversed a district court's holding that there could be no Section 10(b) liability because a fiduciary relationship between the defendants and those with whom they traded did not exist.\(^5\) The Second circuit reasoned that the government was able to avoid the problems of *Chiarella*, i.e., proving a special relationship, by alleging instead that the two broker-defendants breached a duty to their employers.\(^5\) The court then accepted the reasoning of Chief Justice Burger's dissent in *Chiarella*,\(^6\) and held that "deceitful misappropriation of confidential information by a fiduciary... consistently [has] been held to be unlawful."\(^6\) In addition, the court noted that proof of a criminal violation of Section 10(b) is manifestly different from proof of a private action.\(^6\) As a consequence, the traditional need to prove a transaction "in connection"\(^6\) with the "purchase or sale"\(^6\) of a security was relaxed. Instead, the court explained that the defendants "[b]y sullying the repu-

\(^{55}\) Id. at 240 (Burger, C.J. dissenting).
\(^{56}\) Id.
\(^{57}\) Id. at 245. Justices Marshall and Blackmun joined the Chief Justice in his dissenting opinion and commented that "[w]e do not agree that a failure to disclose violates the Rule only when the responsibilities of a relationship of that kind have been breached." Id. at 247 (Marshall and Blackmun, J.J. dissenting).
\(^{59}\) In *Newman*, two stock brokers misappropriated confidential information regarding mergers and takeovers, and conveyed this information to a trader in another brokerage firm who then passed the information on to foreign nationals. These foreign nationals used the information to purchase and sell stock in the target companies, sharing the resulting profits with everyone involved in the scheme.
\(^{60}\) *Newman*, 664 F.2d at 17.
\(^{61}\) See supra notes 54-56 and accompanying text (Burger, C.J. and Marshall and Blackmun, J.J. dissenting).
\(^{62}\) *Newman*, 664 F.2d at 18.
\(^{63}\) Id. at 17.
\(^{64}\) The court applied the flexible standard of Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971), in which the Supreme Court construed the language "in connection with" flexibly to include practices merely "touching" the purchase or sale of securities. See also *Newman*, 664 F.2d at 18.
\(^{65}\) The court noted that the defendants "sole purpose in participating in the misappropriation of confidential takeover information was to purchase shares." 664 F.2d at 18.
tations of [their employers] as safe repositories of client confidences . . . defrauded those employers as surely as if they took their money.”

III. S.E.C. v. MATERIA

FACTS

It was in the foregoing historical context that S.E.C. v. Materia was decided. Anthony Materia was employed as a proofreader by the financial printing firm of Bowne of New York, Inc. Bowne specialized in printing the numerous documents used in connection with proposed takeover offers. In an effort to protect against the disclosure of the identity of potential target companies, code names, blanks and even actual misstatements were included in early drafts of these documents. In addition to Bowne’s intense efforts to protect the identities of takeover targets, Bowne also “had a policy explicitly forbidding its employees from trading on information they might come across in the course of their work.”

Despite these efforts to keep the identity of potential takeover targets secret, between December, 1980 and September, 1982, Materia discovered the true identity of four such targets. Materia purchased stock in these companies within hours of his discoveries, selling his holdings, at substantial profit, after the takeovers were made public.

Shortly after his fourth purchase and sale, the S.E.C. filed a civil enforcement action against Materia. The S.E.C.’s action was based on alleged violations of Section 10(b) and Rule 10b-5 and violations of Section 14(e) of the Exchange Act68 and Rule 14e-3 promulgated thereunder.69 The S.E.C. based the Section 10(b), and Rule 10b-5 claims on Materia’s allegedly “misappropriating material, non-public information about the proposed acquisition of the securities of specific issuers from Bowne’s clients, in breach of his fiduciary duty to Bowne and its clients arising out of his employment relationship and the express internal policy against purchasing securities on the basis of client information.”70

DISTRICT COURT DECISION

The S.E.C.’s case against Materia was heard before District Court

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67. 745 F.2d at 199 n.1 (“Written statements of this prohibition were posted conspicuously in Bowne’s plant, and copies were distributed to all employees.”).
Judge Brieant in a fourteen day non-jury trial. Judge Brieant explicitly found that Materia misappropriated information from his employer and traded on that information to his advantage. Furthermore, the court found that "Materia had actual knowledge . . . and acted with scienter." In addition, the court held that these trades were a direct breach of Materia's fiduciary duty to his employer and his employer's clients. As a result, Materia was found to have violated Section 10(b) and Rule 10b-5. The court then entered a permanent injunction against Materia and ordered him to disgorge $99,862.50 in profits from the four fraudulent purchases and sales.

SECOND CIRCUIT DECISION

The Second Circuit, Judge Kaufman, writing for the court, affirmed the district court's decision. The Second Circuit explicitly adopted the alternate theory of Section 10(b) liability that the Supreme Court never reached in Chiarella. The court in affirming the district court's decision reaffirmed its earlier holding in Newman and stated that "one who mis-appropriates non-public information in breach of a fiduciary duty and trades on that information to his own advantage violates Section 10(b) and Rule 10b-5."  

MATERIA'S PETITION FOR CERTIORARI

In his petition for certiorari, Materia contended that the Second Circuit incorrectly resolved the issue, of misappropriation as a form of Section 10(b) liability, left open by Chiarella. Materia argued that the Second Circuit's decision improperly "federalizes" breaches of fiduciary duty. He questioned whether Section 10(b) and Rule 10b-5 liability is properly based on the use of non-public information when there is no

72. Id. at 97,276.
74. Id. at 97,281.
75. Id. at 97,281-82. The District Court also found Materia guilty of violating Section 14e and Rule 14(e)(3). However, Materia's violations of these latter provisions are beyond the scope of this article.
76. Materia, [1984] Fed. Sec. L. Rep. (CCH) ¶ 91,681 at 99,447 (2d Cir. 1984). In addition Materia was sentenced to five months in jail, four years probation, and 100 hours of service per year of probation. 17 SEC. REG. L. REP. [BNA] 1181 (S.D.N.Y. 1985).
77. 745 F.2d at 203.
78. 745 F.2d at 203.
79. See supra notes 51-55 and accompanying text for a discussion of the issue of misappropriation which was left open in Chiarella.
allegation of a duty to disclose to the purchaser or seller on the other side of the transaction.\textsuperscript{80}

IV. SECOND CIRCUIT'S REASONING IN S.E.C. v. MATERIA

The issue before the Second Circuit in \textit{Materia} was a very narrow one. Materia did not "contest the district court's finding that he misappropriated confidential information and traded on it to his advantage."\textsuperscript{81} Instead, he based his entire appeal on a narrow question of law. Materia simply argued that the activity which the district court found he engaged in "does not contravene Section 10(b) and Rule 10b-5."\textsuperscript{82} In addressing this issue of law, the court noted that Materia's argument directly controverted its earlier decision in \textit{United States v. Newman},\textsuperscript{83} and that the misappropriation of confidential information and the subsequent trading on it "lie[s] within the proscriptive purview of the antifraud provisions of the securities laws."\textsuperscript{84} The court felt that the factual similarity to \textit{Newman} permitted it to affirm solely on the precedential authority of that case.\textsuperscript{85} Nevertheless, the court noted that "to delineate the contours of what may still be perceived as a novel theory of liability under the antifraud provisions, we choose, however, to elucidate the bases for our holding."\textsuperscript{86}

In support of its holding that Materia's misappropriation of material non-public information gives rise to a Section 10(b) and Rule 10b-5 violation, the court turned to the express language of Rule 10b-5.\textsuperscript{87} The court viewed Rule 10b-5 as embodying three distinct concepts: 1) "fraud or deceit"; 2) "upon any person"; and 3) "in connection with the purchase or sale of a security." Turning first to the "fraud or deceit" concept, the court was able to easily\textsuperscript{88} find that Materia's conduct fell "squarely within the 'fraud or deceit' language of the Rule."\textsuperscript{89} In reaching this conclusion, the court explicitly relied on Chief Justice Burger's reasoning in \textit{Chiarella}.\textsuperscript{90} In addition, the Second Circuit reasoned that the original statutory intent behind Section 10(b) and Rule 10b-5 was that the appli-

\textsuperscript{80} [Current] FED. SEC. L. REP. (CCH) ¶ 73,014. Materia also sought review of the validity of Rule 14e-3.
\textsuperscript{81} 745 F.2d at 201.
\textsuperscript{82} Id.
\textsuperscript{83} See supra notes 58-66 and accompanying text.
\textsuperscript{84} 745 F.2d at 201.
\textsuperscript{85} Id.
\textsuperscript{86} Id.
\textsuperscript{87} The language of Rule 10b-5 is quoted supra at note 6.
\textsuperscript{88} See Newman, 664 F.2d at 17.
\textsuperscript{89} 745 F.2d at 201.
\textsuperscript{90} Id. (quoting Chiarella, 445 U.S. 222, 245 (1980) (Burger, C.J. dissenting)).
cation of these anti-fraud provisions should be broad in scope. Relying on the legislative history of the 1934 Act, the court noted that it is "clear that the antifraud provisions . . . [were] intended to be broad in scope, encompassing all manipulative and deceptive practices which have been demonstrated to fulfill no useful function." Therefore, the court concluded that the scope of Section 10(b) extended beyond corporate insiders. Applying this expanded reading of fraud to the facts of this case, the court concluded that Materia's "misappropriation of material nonpublic information . . . perpetrated a fraud upon Bowne," his employer.

Despite finding that Materia's actions were fraudulent, the court recognized that the mere possession of inside information, absent a duty to disclose, does not engender Section 10(b) liability. Instead, the court observed that Section 10(b) is both a civil and criminal piece of legislation. However, when the S.E.C. adopted Rule 10b-5 there was no explicit mention of private civil remedies. It was only after the judiciary's creation of a private Section 10(b) action that the question of standing arose. As a result, in the context of a government enforcement action, the focus is on the scope of the Section's prescriptions rather than the precise direction of a duty. As a consequence, the court found Materia's reliance on Chiarella to be misplaced. Chiarella only decided that mere possession alone does not create a duty to disclose. However, in Newman the court decided that "one who misappropriates non-public information in breach of a fiduciary duty and trades on that information to his own advantage, violates Section 10(b) and Rule 10b-5." Therefore, Materia's fraudulent activities relative to his employer were found to satisfy the "upon any person" language of the section.

92. Materia, 745 F.2d at 201 (quoting S. REP. No. 792, 73d Cong., 2d Sess. 6 (1934)).
93. 745 F.2d at 202. The court also noted that one of Bowne's most important assets, as a financial printer, "is its reputation as a safe repository for client secrets."
94. This issue was decided in Chiarella. See supra notes 44-50 and accompanying text.
95. See Blue Chip Stamps v. Manor Drugs, 421 U.S. 723 (1975) (Discussing standing requirement of purchaser or seller).
96. 745 F.2d at 202.
97. Id. at 203, where the court stated that "mere possession of confidential information is insufficient to create a duty to disclose . . . to those on the other side of the market." Accord Chiarella, 445 U.S. at 235.
99. The court also found that Materia's reliance on the earlier case of Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2nd Cir. 1983), cert. denied sub nom., Moss v. Newman, 104 S. Ct. 1280 (1984), was misplaced. The court reasoned that Moss was strictly limited to cases of civil liability. That case held that absent a duty to disclose, no civil liability could result. Consequently, the court concluded that Moss was clearly not relevant to whether Rule 10b-5 was contravened in a criminal case or a governmental action. Moss only bears on private suits. See, 745 F.2d at 203.
Finally, the court faced the question of whether Materia’s fraud was “in connection with the purchase or sale of securities.” Basing its reasoning on the facts, the court was able to conclude that the fraud on Bowne was undertaken merely to reap profits from the purchase and sale of securities of target companies. Moreover, the court observed that the legislative purpose of the 1934 Act was to prevent such actions. In fact, in affirming the lower court’s decision, the Second Circuit noted that it could not believe Materia’s contention that Section 10(b) did not cover such acts because it was impossible to believe that “the drafters of the Securities Exchange Act of 1934—envisaging as they did an open and honest market—would have countenanced the activities engaged in by Anthony Materia.”

V. ANALYSIS OF S.E.C. v. MATERIA

What separates Materia from previous cases alleging misappropriation as an actionable Section 10(b) violation is the certainty with which the court was able to find liability. Basing its decision on Chief Justice Burger’s dissent in Chiarella and its prior reasoning enunciated in Newman, the Second Circuit gave resounding support to the S.E.C.’s enforcement program against trading on material, ill-gotten, non-public information. On several levels the result reached in Materia is appropriate.

The very enactment of the Federal Securities laws was designed to protect investors against deceitful conduct. Although this protection was never intended to be absolute, the securities laws have always been interpreted to serve a remedial purpose. Securities trading is not on the same plane as “buying a used car,” tricks, chicanery and the like are

100. 745 F.2d at 203.
101. Id. at 201 where the court noted that the “[l]egislative history to the Securities Exchange Act of 1934 makes clear that the anti-fraud provision was intended to be broad in scope, encompassing all [manipulations].” (quoting S. Rep. No. 792, 73d Cong., 2d Sess. 6 (1934)).
102. It is important to note that Materia’s sole argument on appeal is that Section 10(b) and Rule 10b-5 do not cover the acts which he was accused of doing. See supra notes 81-86 and accompanying text.
103. 745 F.2d at 203-4.
not to be countenanced. Congress was not attempting to "take away from the citizen [who trades securities] 'his inalienable right to make a fool of himself.' It simply attempted to prevent others from making a fool of him."107 Commenting indirectly on this underlying purpose, Chief Justice Burger noted a qualitative distinction between trading on an informational advantage based on superior experience, foresight or industry and trading on an informational advantage based on ill-gotten gains.108 It is this very distinction that the Materia court attempted to retain. Mere possession of information or possession based on the admirable qualities enunciated by the Chief Justice are not to be seen as engendering liability. However, the socially reprehensible qualities behind trading based on misappropriated information are to be proscribed. In short, Materia represents a reaffirmation of the principles underlying both the Securities Act of 1934 and ethical business practices.

Furthermore, the court's reliance on a distinction between private and governmental actions is well founded. Under the Securities Exchange Act of 1934, the S.E.C. is expressly authorized to enjoin violations of the Act.109 In contradistinction, private enforcement actions were a creation of the judiciary.110 In an effort to circumscribe these latter actions, the standing requirement of "purchaser and seller" was developed.111 Arguably this standing requirement was applied to private actions so as to reduce vexatious litigation of speculative injuries.112 However, the express language of the Act should govern the requisites to governmental enforcement actions. The authority for governmental actions is based not on judicial pronouncement, but on the statute itself,113 and the statute does not contain the limiting language of purchaser or seller. As a result, to meet the often cited remedial goals of the Act, the Materia court correctly refused to impose the limitation, of purchaser or seller, on an S.E.C. governmental enforcement action.

In his petition for certiorari, Materia questioned the Second Circuit's conclusion on the ground that the decision "federalizes" breaches

107. 1 Loss, Securities Regulation 128 (2d ed. 1961).
Wherever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter...it may in its discretion bring an action in the proper district court....
110. The first case recognizing a private civil right of action under Section 10(b) was Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).
of duties traditionally relegated to state law. It is true that *Materia* established a principle of analysis that may resemble a state common law claim. The case established that one who misappropriates material non-public information, and trades based on it, may be liable even if he owed no duty to the participant on the other side of the trade. However, the case expressly conditioned liability on the existence of a duty between the misappropriator and the entity from whom the information was misappropriated. Facially this conclusion seems to be rooted in the law of agency. However, at common law, the breach of an agency or fiduciary relationship is only actionable by the one whose trust is breached. If left to agency law, Materia’s misappropriation would only be actionable by Bowne, his employer, the one to whom he owed his duty. In contrast, by permitting such a breach of duty to engender Section 10(b) liability, the court implicitly permitted those outside the agency or fiduciary relationship to prosecute these cases. Specifically, such a decision permits the S.E.C. to act in accordance with its legislative mission to oversee securities trading and to place sanctions on this type of activity. If left to agency law the S.E.C. would be powerless to act.

In essence what the *Materia* court did was to accept the “commonsensical view that trading on the basis of improperly obtained information is fundamentally unfair. This fundamental unfairness was recognized over fifty years ago by Judge Cardozo, when he observed that “[m]any forms of conduct permissible, in a workaday world for those acting at arm’s length, are forbidden to those bound by fiduciary ties.” In a similar fashion, because Materia was bound by ties to Bowne, his trading on information misappropriated from Bowne was unfair and should be forbidden. However, the same information, if received from outside of this relationship with Bowne, and not misappropriated, should not and does not engender the same ill-gotten flavor. Because he misappropriated from one he owed a duty, Materia was little more than “a trafficker in stolen goods.” As the Second Circuit had earlier observed in *Newman*,

[i]n other areas of the law, deceitful misappropriation of confidential information by a fiduciary, whether described as theft, conversion, or

114. See, e.g., Restatement (Second) Agency 395, which states: an agent is subject to a duty to the principal not to use or communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency . . .

115. The decision also has the ancilliary benefit of keeping such actions in federal court thereby encouraging uniform results, rather than state specific solutions.


118. 578 F. Supp. at 442.
breach of trust, has consistently been held to be unlawful. [Therefore, one] would have had to be most ingenuous to believe that Congress intended to establish a less rigorous code of conduct under the Securities Acts. Consequently, the decision in Materia, as a matter of public policy, is commendable.

VI. The Supreme Court And The Misappropriation Theory

On December 27, 1984, Materia petitioned the Supreme Court for a writ of certiorari. Although the Court denied Materia's petition, in light of the separate opinions in Chiarella and the language contained in Dirks v. S.E.C., there is compelling evidence that a majority of the Court would embrace the misappropriation theory.

In Chiarella, Justice Stevens gave implicit approval to the misappropriation theory of liability when he noted that respectable arguments could be made in support of its approval as a theory of Section 10(b) liability. In addition, Justice Brennan commented that he was unable to subscribe to the Chiarella majority's position that there can be no Section 10(b) liability without a breach of some duty arising from a fiduciary relationship between the buyer and seller of securities. This statement by Justice Brennan is indicative of his reluctance to limit Section 10(b) to situations where there is an identifiable Cady, Roberts duty. Instead, a broader application of Section 10(b) is warranted. This search for a broader application is to be found in the misappropriation theory.

Clearly, Chief Justice Burger, whose reasoning the Materia and Newman decisions are based on, would approve the theory. In addition, Justices Marshall and Blackmun, who joined in a separate concurring dissent in Chiarella, would find a basis for liability in the misappropriation theory. Their displeasure with the limited scope of the Chiarella majority's holding was evidenced when they commented that they did not agree with the majority's holding that "a failure to disclose violates . . . Rule [10(b)] only when the responsibilities of a [fiduciary] relationship have been breached." Furthermore, though reversing Chiarella's conviction, the Chiarella majority never expressly rejected the

120. See supra notes 78-80 and accompanying text.
122. Chiarella, 445 U.S. at 238 (Stevens, J. concurring).
123. Id. at 239 (Brennan, J. concurring).
124. See supra notes 55-57 and accompanying text regarding a discussion of Chief Justice Burger's dissent.
misappropriation theory. As a result, five justices,\textsuperscript{126} at a minimum, have expressed some level of support for the theory and the remaining four justices left open the door to consider the theory.

In \textit{Dirks v. S.E.C.}, the Court addressed the extent to which Section 10(b) would be applied to tippers and tippees of material, non-public information.\textsuperscript{127} In that case, the S.E.C. argued that Dirks, as a tippee, inherited the obligation not to trade on non-public information when he acquired the information from the corporate insider, a tipper. The Court held that a tippee's duty is derivative and his actions are only actionable when "there has been a breach of duty by the insider, [the tipper]."\textsuperscript{128} Moreover, the test for whether the insider-tipper has breached this duty is "whether the insider personally will benefit, directly or indirectly, from his disclosure."\textsuperscript{129} The Court concluded that because the tipper received no such benefit, Dirks' actions did not constitute a Section 10(b) violation.

However, prior to making this finding, the court found it necessary to explicitly rule out liability based on misappropriation. The Court commented that "Dirks [did not] misappropriate or illegally obtain the information" at issue.\textsuperscript{130} This statement by the Court seems to indicate at least an implicit recognition that misappropriation \textit{can} form the basis of a Section 10(b) violation. This recognition comes despite the fact that the Court has neither heard a misappropriation case nor expressly recognized misappropriation as being an actionable Section 10(b) act. Consequently, based on this recognition and that of the separate opinions of \textit{Chiarella}, there is convincing evidence that the current Court if presented with the appropriate case would approve the theory of misappropriation as an alternate basis of liability under Section 10(b).

\textsuperscript{126} Burger, C.J., Stevens, J., Brennan, J., Marshall, J., and Blackmun, J.
\textsuperscript{127} 463 U.S. 646 (1983). The \textit{Dirks} case concerned the liability of a broker-dealer specializing in investment analysis. Raymond Dirks received information from a corporate insider regarding the overstatement of the assets of Equity Funding of America. He investigated this information and determined its validity. Throughout his investigation he openly discussed his findings, even going so far as to suggest to the Wall Street Journal that it write a story on Equity Funding's asset overstatement. Based on Dirks' findings, several of his clients sold their holdings in Equity Funding. Later the New York Stock Exchange and the California Insurance Commission conducted their own investigations of Equity Funding. These investigations resulted in a trading halt of Equity Funding and an impounding of its assets. The S.E.C. then brought an action for violation of Section 10(b) against Dirks for repeating allegations of fraud to members of the investment community who later sold their Equity Funding stocks. \textit{Id.} at 648-51.
\textsuperscript{128} \textit{Id.} at 663.
\textsuperscript{129} \textit{Id.} at 662.
\textsuperscript{130} \textit{Id.} at 665.
VII. CONCLUSION

Even though the Supreme Court in *Chiarella* dictated that the securities laws do not guarantee equal access to information, the decision in *S.E.C. v. Materia*, which proscribed certain informational advantages, is sensible on both a legal and a commonsensical basis. The elimination and prevention of the type of profiteering engaged in by Materia lies at the root of the federal securities regulations. By stepping away from previously used, ultrafine distinctions based on the relationship between buyers and sellers of securities, the *Materia* decision firmly reinforces the remedial goals of the securities laws as they were originally enacted. Moreover, based on its prior decisions in *Chiarella* and *Dirks*, there is a compelling indication that the current Supreme Court would place its judicial stamp of approval on misappropriation as an actionable form of fraud under Section 10(b). Although the Court refused to hear the *Materia* case, when an “another day” finally comes, the Court will be able to bring semblance to this novel theory of securities fraud.