Municipal Assistance Corp.
2 World Trade Center
New York, N.Y. 10047

Charge Number 021772567
Commissioner Colston H. Lewis
vs.
Respondent Municipal Assistance Corp.

Dear Sir/Madam:

This is to inform you that the Commissioner's Charge referenced above has been withdrawn pursuant to Section 1601.11(b) of the Commission's Regulations. Copies of the Charge and the Regulation have been enclosed for your information.

This withdrawal does not affect the processing of any other charge, including, but not limited to, another Commissioner's Charge or a charge whose allegations are like or related to the allegations contained in the Commissioner's Charge withdrawn.

If you have any questions concerning this matter, please address them to Electra Yourke, Director, Investigations Division, Office of Systemic Programs, Equal Employment Opportunity Commission, 2401 E Street, N.W., Washington, D. C. 20506.

On behalf of the Commission,

[Signature]
Acting Executive Officer
Executive Secretariat

Enclosure
COMMISSIONER'S CHARGE

Pursuant to Section 706(a) and (b) of the Civil Rights Act of 1964, as amended (Title VII), I charge the following employees with unlawful employment practices:

Municipal Assistance Corporation
New York, New York

Emergency Financial Control Board
New York, New York

New York City Health and Hospitals Corporation
125 Worth Street
New York, New York 10013

I believe and allege that the above employer, New York City Health and Hospitals Corporation, is within the jurisdiction of the Equal Employment Opportunity Commission and has violated and continues to violate Section 703(a) of Title VII of the Civil Rights Act of 1964, as amended by discrimination against Blacks and Spanish surnamed Americans on the basis of race and national origin with respect to recruitment, hiring, job assignment, promotion, compensation, discharge, and other terms and conditions of employment:

1. Respondent Employer discriminately fails and refuses to recruit and hire Blacks and Spanish surnamed Americans in the same manner as it recruits and hires Caucasians.

2. Respondent Employer discriminately limits Black males and Spanish surnamed Americans from higher paying positions as officials and professionals.

3. Respondent Employer discriminately assigns and limits Blacks and Spanish surnamed Americans to traditionally lower-paying positions with less opportunity for advancement than those positions to which it assigns Caucasian employees.
identity confidential. However, such request for confidentiality shall not prevent the Commission from disclosing the identity to federal, state or local agencies that have agreed to keep such information confidential. If this condition is violated by a recipient agency, the Commission may decline to honor subsequent requests for such information.

(b) The person claiming to be aggrieved has the responsibility to provide the Commission with notice of any change in address and with notice of any prolonged absence from that current address so that he or she can be located when necessary during the Commission's consideration of the charge.

§ 1601.8 Where to make a charge.
A charge may be made in person or by mail at the offices of the Commission in Washington, D.C., or any of its district or area offices or with any designated representative of the Commission. The addresses of the Commission’s district offices appear in § 1610.4. (Sec. 1601.8 reads as last amended, effective February 20, 1979)

§ 1601.9 Form of charge.
A charge shall be in writing and signed and shall be verified.

§ 1601.10 Withdrawal of a charge by a person claiming to be aggrieved.
A charge filed by or on behalf of a person claiming to be aggrieved may be withdrawn only by the person claiming to be aggrieved and only with the consent of the Commission. The Commission hereby delegates authority to District Directors, Area Directors, the Director of the Office of Field Services and the Director of the Office of Systemic Programs, or their designees, to grant consent to a request to withdraw a charge, other than a Commission charge, where the withdrawal of the charge will not defeat the purposes of Title VII. (Sec. 1601.10 reads as last amended, effective February 20, 1979)

§ 1601.11 Charges by members of the Commission.
(a) Any member of the Commission may file a charge with the Commission. Such charge shall be in writing and shall be verified.
(b) A Commissioner who files a charge under paragraph (a) of this section may withdraw the charge with the consent of the Commission. The Commission may withdraw any charge filed under paragraph (a) of this section by a Commissioner who is no longer holding office when it determines that the purposes of title VII are no longer served by processing the charge. Commissioner charges may not be withdrawn pursuant to this section after a determination as to reasonable cause has been made. This paragraph does not apply to a charge filed by a Commissioner which is on behalf of a person claiming to be aggrieved within the meaning of § 1601.7 unless such person submits a written request for withdrawal to the Commission. (Section 1601.11 reads as last amended effective July 18, 1978.)

§ 1601.12 Contents of charge; amendment of charge.
(a) Each charge shall contain the following: (1) The full name, address and telephone number of the person making the charge except as provided in § 1601.7;
(2) The full name and address of the person against whom the charge is made, if known (hereinafter referred to as the respondent);
(3) A clear and concise statement of the facts, including pertinent dates, constituting the alleged unlawful employment practices: See § 1601.13(b);
(4) If known, the approximate number of employees of the respondent employer or the approximate number of members of the respondent labor organization, as the case may be; and
(5) A statement disclosing whether proceedings involving the alleged unlawful employment practice have been commenced before a State or local agency charged with the enforcement of fair employment practice laws and, if so, the date of such commencement and the name of the agency.
(b) Notwithstanding the provisions of paragraph (a) of this section, a charge is sufficient when the Commission receives from the person making the charge a written statement sufficiently precise to identify the parties, and to describe generally the action or practices complained of. A charge may be amended to cure technical defects or omissions, including failure to verify the charge, or to clarify and amplify allegations made
UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

-------------------------------------

IN RE NEW YORK CITY MUNICIPAL SECURITIES LITIGATION  : MDL Docket No. 314

-------------------------------------

OWEN, District Judge

In this multi-faceted litigation, before me for pre-trial purposes pursuant to an order of the Judicial Panel on Multidistrict Litigation, there are various motions to dismiss. These actions have a common origin in the near financial collapse of the City of New York in late 1974 and early 1975. (1) The several complaints allege that the City of New York, former Mayor Abraham Beame and Comptroller Harrison Goldin (the "City Defendants"), and certain banks and brokerage firms (the "Underwriter and Seller Defendants") deliberately misled the public as to the City's desperate financial condition in connection with the underwriting and subsequent resale of various New York City obligations issued during 1974 and 1975. (2) Plaintiffs allege that the foregoing constitutes violations of Section 17(a) of the Securities Act of 1933 (the "Securities Act" or the "1933 Act"), 15 U.S.C. § 77q(a) and Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act" or the "1934 Act"), 15 U.S.C. § 78j(6) and Rule 10b-5
promulgated thereunder, 17 C.F.R. § 240.10b-5.

Eleven separate lawsuits have been consolidated for pretrial matters in this litigation. In five of the actions, the City is named as a defendant along with the underwriters and sellers. Two of the actions have been certified as class actions pursuant to Fed.R.Civ.P. 23(b)(3), Friedlander v. City of New York, 71 F.R.D. 546 (S.D.N.Y. 1976), and Specter v. City of New York, 71 F.R.D. 550 (S.D.N.Y. 1976). In Friedlander, plaintiffs allege that on June 1, 1974, New York City had outstanding $4.4 billion short-term notes, of which the defendant banks held approximately $3.5 billion, and of which large clients of the defendant brokers owned approximately $900 million. (Plaintiff's Complaint at ¶ 31.) According to the complaint, based on "inside" information that the City was unable to repay these obligations, the underwriter defendants underwrote for distribution to the general public approximately $2.6 million of the City's notes. The proceeds of these sales were allegedly to be used to "bail out" the banks' and brokerage firms' own holdings of City notes by reducing those holdings from $4.4 million in June 1974 to $1.9 million in June 1975. The City of New York and its Mayor and Comptroller are alleged to have aided and abetted the foregoing acts by, inter alia, concealing the City's critical financial condition from the public and falsifying certain records to conceal the fiscal crisis. The Friedlander class

The Spector class consists of the holders of the City's general obligation bonds who purchased such bonds between May 1, 1974 and September 30, 1975. Plaintiffs allege that the commercial banks and brokerage firms conspired to conceal information as to the City's desperate financial condition from the investing public. These acts of concealment, along with other short term steps designed to avoid default, were allegedly taken to preserve prevailing bond prices to allow the defendants to profitably dispose of their own holdings of City bonds. Certain of the defendants are said to have reduced their holdings in City bonds from $2.5 billion on May 1, 1974 to virtually nil by the time the prices of those bonds plummeted. Here, as in Friedlander, the City is alleged to have aided and abetted this conspiracy by virtue of material misrepresentations and non-disclosures to the public concerning the City's finances. Plaintiffs contend that as a result of the acts of the City defendants and the underwriter/defendants, the members of the class -- predominately "after-market" purchasers of the City general obligation bonds -- incurred substantial economic losses.
The allegations in *Goldfarb, Weisberg* and *Manchester* are essentially the same as those in *Friedlander* and *Spector*. The remaining cases, while not alleging securities fraud on the part of the City defendants, allege violations of § 17(a) of the Securities Act and/or § 10(b) of the Securities Exchange Act by certain of the commercial banks or brokerage firms.\(^{(5)}\) It is undisputed that all of the conduct at issue occurred prior to the enactment of the 1975 amendments to the Securities Exchange Act.

The City and the underwriter and seller defendants move to dismiss for failure to state a claim upon which relief may be granted, Fed.R.Civ.P. 12(b)(6),\(^{(6)}\) on the following legal theories:

1. That transactions involving municipal securities whether by the City, the underwriters or other sellers, are not covered by § 10(b) of the Securities Exchange Act; and, consequently, no private right of action is conferred upon a purchaser of such securities; and

2. That while § 17(a) of the Securities Act expressly includes municipal securities and has been construed to confer enforcement rights upon the Securities Exchange Commission ("SEC") in the event of violations, it does not confer a private right of action upon an investor; and
(3) That if the antifraud provisions of the securities laws apply to municipal securities, the tenth amendment to the United States Constitution would render such provisions unconstitutional as applied to the City defendants.

In the alternative, certain of the underwriter defendants argue that if a private right of action does exist as to them with respect to transactions in municipal securities, it must also be implied against the City as issuer.

From a careful consideration of the 1933 and 1934 Acts (and their amendments) viewed in the light of their extensive legislative histories and the relevant case law, I conclude that the motions of the City defendants to dismiss should be granted, while those of the underwriter and seller defendants should be denied.

I. The Applicability of § 10(b) of the Securities Exchange Act to Municipal Securities and to the Underwriters and Sellers Thereof.

The threshold question presented is whether the private right of action unquestionably available to a purchaser of corporate securities under § 10(b) of the 1934 Act, (7) and Rule 10b-5 promulgated thereunder, (8) is equally available to a purchaser of municipal securities. This is "basically a matter of statutory construction." Trans-America Mortgage Advisors v. Lewis, 48 U.S.L.W. 4001 (November 13, 1979).
The Securities Exchange Act was designed "to provide for the regulation of securities exchanges and of the over-the-counter markets . . . to prevent inequitable and unfair practices in such exchanges and markets . . ." Senate Report No. 792, 73rd Cong. 2d Sess., at 1. Nevertheless, Congress, by including § (3)(a)(12), 15 U.S.C. § 78c(a)(12) in the 1934 Act, clearly contemplated that, at least for some purposes, governmental securities, including those of municipalities, would be exempted from certain of its requirements. The defendants argue that the mere inclusion of § 3(a)(12) in the 1934 Act evidences a Congressional intent to exempt municipal securities from the operation of § 10(b). I reject this contention.

At the time of the events in question, § 3(a)(12) defined an "exempted security" as follows:

The term "exempted security" or "exempted securities" includes securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States; . . . securities which are direct obligations of or obligations guaranteed as to principal or interest by a State or any political subdivision thereof, or by any agency or instrumentality of a State or any political subdivision thereof, or by any municipal corporate instrumentality of one or more states; . . . and such other securities . . . as the Commission may, by such rules and regulations as it deems necessary or appropriate in the public interest or for the protection of investors, . . . exempt from the operation of any one or more provisions of this chapter which by their terms do not apply to an "exempted security" or to "exempted securities."

This section is strictly definitional. Whether or not a given substantive section applies to "exempted securities" is left to the express language of the particular section. In the Senate Report on the 1934 Act, the draftsmen confirm this view by noting that a "large number of the provisions in the Act expressly include 'exempted securities'". (9) In short, when Congress wanted to exclude exempted securities from a section of the Act, it knew how to do so. (10) It is significant, therefore, that the language of § 10(b) does not evidence such an intent. That section makes it unlawful for "any person . . . 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. . . . " (emphasis added). The Congressional intent to have § 10(b) extend to fraudulent conduct in connection with all securities in the broadest sense, including those defined in § 3(a)(12) could not be clearer. The draftsmen not only omitted reference to "exempted securities," they also specifically included both registered and unregistered securities, as well as transactions on the national securities exchange and the over-the-counter market.

The legislative history of § 3(a)(12) further demonstrates that it only serves to define "exempted securities." The original draft of § 3(a)(12) expressly
exempted only United States Government securities, and the Federal Trade Commission was to be vested with the authority to broaden the scope of § 3(a)(12). In discussing this grant of authority, the draftsmen indicated that

A large number of provisions in the act expressly exclude "exempted securities." Thus the Commission is able to remove from the operation of any one or more of these provisions any securities as to which it deems them inappropriate. (Emphasis added)

H.R. Rep. No. 1383, 73rd Cong., 2d Sess., 17 (1934); see also Senate Rep. No. 792, 73rd Cong., 2d Sess., 14 (1934). Thus, Congress granted the Commission the authority to add other securities to the list of exempted securities, but it did not empower the Commission to exclude "exempted securities" from other sections of the Act. That Congress later expanded the definition of "exempted securities" to include those of state and municipal issuers does not alter the limited function of § 3(a)(12).

It is also clear that obvious political considerations motivated Congress to enact the exemptions it eventually provided for municipal securities in the 1933 and 1934 Acts. Landis, The Legislative History of the Securities Act of 1933, 28 Geo. Wash. L. Rev. 29, 39 (1959). The political, as well as economic, justifications underlying
§ 3(a)(12) are most visible in the Congressional hearings on the 1934 Act. Paramount among the political concerns was the impact on federal-state relations of vesting the Federal Trade Commission with the discretionary authority to affect the credit of a state or municipality. Senate Hearings, supra, at 7477. In testimony before the Senate, George B. Gibbons, a New York City municipal bond dealer, highlighted the danger of vesting such power in the Federal Trade Commission:

State bonds and the bonds of their political subdivisions and agencies are not exempted by the provisions of this Act, and they are under the power of the Federal Trade Commission. That gives them, if they so care to use it, a very dangerous power over the financial affairs of all the states, cities, counties and political subdivisions and agencies in them; and it might be exercised to their great disadvantage.

The credit of a state, or a municipality or agency within it, and its ability to finance its many needs for roads, schools, preservation of health, and so on, would be seriously crippled by the refusal of the Federal Trade Commission to exempt its bonds or by the imposing of unreasonable conditions for granting such exemptions, and cause irreparable damage and loss to both the State or municipality and to the holders of their outstanding bonds by the withdrawal of exemption in cases where it had once been granted.

Senate Hearings, supra, at 7446. (13) In fact, these very same objections prompted one member of the House Committee to note that "a real [constitutional] question" existed as to "the power of Congress to place any burden upon a state
in the marketing of its bonds . . . ." House Hearings, supra, at 822.

An equally compelling argument was addressed to Congress detailing the economic impact of failing to include state and municipal obligations in § 3(a)(12). Numerous witnesses observed that the failure to provide a blanket exemption for municipal and state obligations, while providing such an exemption for securities of the federal government, would impose a serious economic burden on the non-exempted securities. See, e.g., House Hearings, supra, at 721. As one witness explained to the Senate Committee:

The inclusion of State and municipal bonds in the bill does not confer any benefit on the holders of municipal bonds nor on the municipalities issuing them. On the contrary, it imposes a very distinct hardship on both municipalities and the purchasers of their bonds and will seriously affect their value as an investment. The exemption of a municipal bond would not add to its present value, and refusing exemption would seriously impair its value.

If being exempted from this bill is helpful to the United States Government bonds, certainly States and municipalities need that help also. If not being exempted would be harmful to Government bonds, certainly States and municipalities should not suffer that harm.

Senate Hearings, supra, at 7445. See also Id. at 7444.(14)

It was also urged that municipal securities were simply not subject to the same "speculative abuses" as were corporate securities because: (1) there is "practically no
speculation" in the municipal market; (2) the purchasers of municipal securities are large, sophisticated public institutions and corporations; and (3) the relatively small number of municipal securities made it "almost impossible to effect wash sales" and "practically impossible to sell municipal bonds short." See, Senate Hearings, supra, at 7443.

As this legislative history documents, the addition of municipal and state securities to the category of "exempted securities" as defined in § 3(a)(12) evidences essentially a Congressional decision to avoid the political and economic consequences of unequal treatment of federal, state and municipal securities. It does not reflect a legislative intent to exempt municipal securities from the provisions of § 10(b) of the 1934 Act. On the contrary, the legislative debates over the scope of the § 3(a)(12) definition of "exempt securities" compel just the opposite conclusion.

Of paramount concern to the draftsmen of the original version of § 3(a)(12) -- the same individuals who drafted § 10(b) -- was the protection of investors in municipal and state securities. Thus, it is quite clear from the legislative record that the draftsmen's initial omission of municipal securities from § 3(a)(12) can be explained by the fact that
at the time it was drafted approximately 17,300 municipalities -- about 1% of the municipalities in America -- were either delinquent or in default. House Hearing, supra, at 822. See also Senate Hearings, supra, at 7413. Congress was apparently convinced that these investors were entitled to the fullest possible protection with regard to these securities. Senate Hearing, supra, at 7477. See also House Hearing, supra, at 821, 822.

Thus, while the desire to maintain political and economic parity among governmental issuers led to the eventual inclusion of municipal securities in the definition of "exempted securities," Congressional concern for investor protection from the practices of certain sellers of municipal securities remained. In an exchange that suggests the reason why "exempted securities" were not expressly excluded from § 10(b), Senator Gore inquired:

Is there any way that you could vest the administrative agency with the power to forewarn prospective purchasers that the bond of a certain town is a bad investment? Is there any red light at all? One of the objects of this bill is to protect the fool against his follies. I do not know whether they can do it or not, but I do not see any difference between the man that loses his money by buying municipal bonds that are no good, I do not see that he is any better off than if he put it in a railroad bond or a chewing-gum factory bond or something of that sort. He lost his money . . . .

Senate Hearings, supra, at 7450. In fact, evidence of fraud
and misrepresentations in the sale of municipal securities to the public was frequently brought to the attention of the Senate Committee. See, Senate Hearings, supra, at 232.

Finally, strong support for the view that the drafts-
men of § 10(b) and § 3(a)(12) were concerned with protecting the investor in municipal securities may be found in the testimony of Commissioner Landis.\(^{(16)}\) In response to Representative Pettengill's charge that municipal securities were being "overregulated" by the proposed draft of the 1934 Act, Commissioner Landis stated:

Well, in answer to your first question, I would have to answer that first question yes, there are abuses there [in the municipal securities market]. How widespread they are, and how important they are is a pretty hard matter to guess at, . . ., and we cannot, of course, say there are no abuses in the trading of municipal securities. Unquestionably there are salesmen who trade in municipal securities, deal in them, sell them, and will not tell the purchasers that they are in default. They are not reputable sales-
men, of course, but there have been things like that done, unquestionably.

Furthermore, one of the things in municipal securities is that you must differentiate between general obligations of a municipali-
ity, and special obligations . . . . That distinction is often not made by the salesman. It escapes the prospective purchaser of these bonds, and sometimes because the salesman wishes it to escape.

House Hearing, supra, at 697. Based on this legislative history, I must conclude that while municipal securities
were ultimately included in the definition of "exempt securities" in § 3(a)(12), they were not thereby removed from the strictures of § 10(b) of the 1934 Act.

The case law supports the existence of an implied cause of action under § 10(b) of the 1934 Act in favor of purchasers of municipal securities. The Supreme Court's decision in Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971), where the underlying securities were United States Treasury bonds, firmly established a private cause of action under § 10(b) in favor of the seller of any securities -- whether or not exempted under § 3(a)(12). The unanimous Court stated in broad language that "[s]ection 10(b) outlaws the use 'in connection with the purchase or sale' of any security of 'any manipulative or deceptive device or contrivance,' " 404 U.S. at 10. In a footnote the Court adds that "[s]ection 3(a)(10) of the 1934 Act defines 'security' very broadly . . . and clearly embraces Treasury bonds." (17) 404 U.S. at 10 n.6. Thus, the Superintendent result demonstrates that the definition of "a security" for the purposes of § 10(b) includes all those securities enumerated in § 3(a)(10), including municipal securities.

holding of Superintendent of Insurance. I reject this contention. Cannon recognized that although the language of § 10(b) is merely duty-creating, as opposed to right-creating, ever since "Superintendent of Insurance, the [Supreme] Court [has] explicitly acquiesced in the 25 year-old acceptance by the lower federal courts of 10b-5 causes of action. See also Ernst & Ernst v. Hockfelder, 425 U.S. 185, 196 . . .; Blue Chip Stamps v. Manor Drug, 421 U.S. 723, 730 . . .." Cannon v. University of Chicago, supra, at 1955 n. 13. Superintendent of Insurance "reflects the unique history of § 10b-5," Cannon v. University of Chicago, supra, at 1979, and its holding is unaffected by recent decisions applying a more restrictive standard on implication of private rights of action.

1955); Connecticut Mutual Life Ins. Co. v. Shields, 131 F. Supp. 363 (S.D.N.Y. 1954); Baron v. Shields, 131 F. Supp. 370 (S.D.N.Y. 1954). Moreover, courts have uniformly rejected the argument advanced here by the defendants that because the express civil liability provisions of § 12(2) of the 1933 Act, 15 U.S.C. § 77q(2) (16) exempt governmental securities, (19) purchasers of those securities should not be permitted to circumvent that exception by suing under § 10(b) of the 1934 Act. (20) In Thiele v. Shields, supra, the court explained:

That Congress intended to exempt a seller of municipal bonds from liability for failure to prove that he exercised reasonable care in investigating the truth of a representation is not inconsistent with the subject of civil liability of the same seller after the purchaser proves that he knowingly misrepresented a fact.


In the present litigation, the plaintiffs allege that
the commercial banks and brokerage firms engaged in a conspiracy to defraud the purchasers of New York City bonds and notes. The language and legislative history of § 10(b), as well as the legal precedents recognizing an implied private remedy on behalf of the defrauded purchasers, support the conclusion that § 10(b) applies to municipal securities and to the underwriters who sell them. The underwriter and seller defendants' motion to dismiss the § 10(b) cause of action as to them is accordingly denied.

II. The Applicability of § 10(b) to Municipal Issuers:
The City of New York and its Officials.

On its motions to dismiss, the City first contends that § 10(b) does not apply to municipalities. Although I have concluded that § 10(b) extends to transactions in municipal securities, I also conclude that as "person" is defined in the 1934 Act, liability under § 10(b) does not reach a municipal issuer.

Section 10(b), and Rule 10b-5 promulgated thereunder, make it unlawful for "any person" to engage in fraud in the sale or purchase of "any security." At the time of the events in suit, and prior to its amendment on June 4, 1975, § 3(a)(9) of the 1934 Act defined "person" as follows:

The term "person" means an individual, a corporation, a partnership, an association, a joint-stock company, a business trust, or an unincorporated organization. 1934 Act, ch. 404, § 3(a)(9), 45 Stat. 292.
This definition of "person" does not, by its terms, apply to municipalities, states or the federal government. Nor can such entities be included by implication. This is clear from a comparison of § 3(a)(9) of the 1934 Act with § 2(2) of the 1933 Act, 15 U.S.C. § 77b(2) in which Congress expressly included governmental entities:

The term 'person' means an individual, a corporation, a partnership, an association, a joint-stock company, a trust, any unincorporated organization, or a government or political subdivision thereof. (25) (Emphasis added.)

Moreover, in June of 1975, Congress found it necessary to amend § 3(a)(9) to expressly include a "government, or political subdivision, agency, or instrumentality of a government." Pub. L. 94-29, § 3, 89 Stat 97 (1975), 15 U.S.C. § 78(c)(9) (1977 Supp.). Thus, the omission of express reference to these entities in § 3(a)(9) of the 1934 Act reflects a decision not to include governments within that section.

While the plaintiffs and certain defendants argue, nonetheless, that the difference between the definition of "person" in the 1934 Act and the 1933 Act are merely "stylistic," the legislative history and statutory framework of the securities laws contradict this view. Regulation of governmental instrumentalities was carefully avoided in both the 1933 and 1934 Acts. Congressional reluctance to subject governmental issuers to the civil liability provisions of the securities laws is clearly expressed
in the House Report accompanying the 1933 Act. There, the Committee, explaining the reasons for the § 3(a)(2) exemption for governmental issuers, stated:

Paragraph (2) exempts United States, Territorial and State obligations, or obligations of any political subdivision of these governmental units. The term "political subdivision" carries with it the exemption of such securities as county, town, or municipal obligations, as well as school district, drainage district, ... The line drawn by the expression 'political subdivision' corresponds generally with the line drawn by the courts as to what obligations of States their units and instrumentalities created by them, are exempted from Federal taxation. By such a delineation, any constitutional difficulties that might arise with reference to the inclusion of state and municipal obligations are avoided.


These same constitutional limitations, real or imagined, upon Congress' authority to subject governmental issuers to the regulatory scheme were an obvious factor leading to the exemption of such issuers from § 5 and § 12(2) of the 1933 Act. (26) One year later, after further hearings on the constitutional political and economic impact of regulations affecting governmental issuers, Congress continued to be of the same view and exempted transactions in government obligations from certain provisions of the 1934 Act. (27) The definition of "person" in the 1934 Act, operating as it does to remove governmental instrumentalities from the civil liability provisions of § 10(b), simply furthers the Congressional policy announced in the 1933 Act.
This analysis is not inconsistent with my earlier conclusion that Congress intended underwriters and sellers to be liable under § 10(b) for their own independent fraudulent conduct in connection with municipal securities. The underwriter defendants argue, by analogy, that since § 12(2) of the 1933 Act exempts both municipal issuers and underwriters, any exemption for municipal issuers under § 10(b) of the 1934 Act necessarily extends to underwriters. The underwriters cannot claim a "derivative immunity" such as that afforded underwriters under § 12(2) of the 1933 Act. It is true that the Congressional protection afforded governmental issuers under § 12(2) similarly shields underwriters from liability for negligent misrepresentations or omissions. However, § 12(2) exhibits nothing more than a Congressional intent not to impose the disclosure burden of § 5 of the 1933 Act on governmental issuers, and not to shift that responsibility to the underwriters of governmental obligations. By contrast, in § 10(b) of the 1934 Act, Congress clearly intended to differentiate between the governmental issuer on the one hand, and underwriters and sellers on the other. Although the debate on the 1934 Act reveals no evidence of a Congressional concern with fraud on the part of governmental issuers, the same cannot be said of Congress' attitude toward others doing business in municipal securities. As observed earlier in the discussion of the
scope of § 10(b), Commissioner Landis testified before Congress that some sellers of municipal bonds had defrauded the investing public. House Hearing, supra, at 897. (28) Congress' decision to subject underwriters and sellers of municipal securities to civil liability under § 10(b) for their own fraudulent conduct understandably followed.

Next, it has been argued that Congress, by redefining "person" to include a municipality in the 1975 Amendments to 1934 Acts, merely made explicit what had all along been the case. The legislative history, however, compels the opposite conclusion. (29) Although Congress sought to establish a regulatory scheme for the municipal securities market by the adoption of the 1975 amendments, (30) what Commissioner Landis referred to as "obvious political reasons" again led Congress to regulate municipal securities dealers but to exempt the municipalities themselves. Concern that "even if regulation were limited to dealers, it would inevitably have consequences for issuers." (31) prompted the adoption of the Tower Amendments. These amendments attempted to limit the "collateral effect" of the 1975 Amendments (32) on issuers in the following way:

(d)(1) Neither the Commission nor the Board is authorized under this chapter, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection
with the issuance, sale, or distribution of such securities.

(2) The Board is not authorized under this chapter to require any issuer of municipal securities, directly or indirectly through a municipal securities broker or municipal securities dealer or otherwise, to furnish to the Board or to a purchaser or a prospective purchaser of such securities any application, report, document, or information with respect to such issuer.

15 U.S.C. § 78-4(d). The aim of the Tower Amendments was to insure that the 1934 Act (as amended) would not "tamper in any way with prerogatives of state and local governments in their sale of securities." 121 Cong. Rec. 6188 (1975) (Remarks of Senator Williams). Thus, in 1975 Congress merely ratified the approach taken in 1934 with respect to municipal securities. It chose, again, for possibly "obvious political reasons," to exempt municipalities themselves from regulation while subjecting others in the municipal securities market to the Act's regulatory scheme.

The legislative history of the 1975 Amendments to the Exchange Act is not silent on the question of the applicability of the antifraud provisions of the securities laws to municipal securities. However, as the following comment from the Senate Report indicates, the record is somewhat ambiguous:

The Committee is mindful of the historical relationship between the federal securities laws and issuers of municipal securities. Apart from the general antifraud provisions, municipal securities are exempt from all substantive requirements.

S. Rep. No. 94-75 at 44. See also Id. at 45. First,
this statement merely confirms that § 10(b) was intended to
cover transactions in municipal securities. Second, as dis-
cussed infra, this statement accurately reflects the fact
that § 17(a) expressly subjected municipal issuers to the
injunctive and criminal provisions of the 1933 Act. See
Proposed Amendments to the Securities Exchange Act of 1934:
Hearings on S. 249 Before the Subcomm. on Securities of the
Senate Committee on Banking, Housing and Urban Affairs,
94th Cong., 1st Sess. 476-79 (1975). Whatever effect the
1975 Amendments may have had on the amenability of govern-
mental issuers to civil liability under § 10(b) in future
lawsuits, (35) nothing in the legislative history of those
Amendments indicates that prior to their enactment § 10(b)
was meant to give rise to a private cause of action against
a governmental issuer.

Contrary to the plaintiffs' contention, the Second
Circuit in Forman v. Community Services, Inc., 500 F.2d 1246
(2d Cir. 1974), rev'd on other grounds sub nom. United Hous-
ing Foundation v. Forman, 421 U.S. 837 (1975) did not have
before it the question presented here. In Forman, the plain-
tiffs, purchasers of shares in a New York State financed
cooperative apartment, brought suit against several corporate
defendants under § 10(b) of the 1934 Act and § 17(a) of the
1933 Act. Significantly, the plaintiffs also sought to
recover damages from the New York State Housing Finance Agency and the State of New York alleging violations of 42 U.S.C. § 1983 arising out of the same conduct which gave rise to the § 10(b) claims asserted against the other defendants. Thus, the Forman court had no occasion to consider whether § 10(b) applied directly to governmental issuers.

While Forman did not have the question before it, courts that have considered whether § 10(b) extends to municipalities agree that it does not. Decisions in the Second Circuit and in this district have acknowledged the fact that the definition of "person" in § 3(a)(9) of the 1934 Act did not include municipalities. In Monell v. Department of Social Services of the City of New York, 532 F.2d 259 (2d Cir. 1976), rev'd on other grounds, 436 U.S. 653 (1978) the court, in a footnote, observed that:

>The definition of "person" in §3(a)(9)
of the Securities Exchange Act of 1934
did not include governmental agencies until
the 1975 amendments of § 3(a)(9) . . . .

532 F.2d at 263 n.3. Two recent district courts expressed the same view. In Greenspan v. Crosbie [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,780 (S.D.N.Y. 1976), the court dismissed a lawsuit brought under § 10(b) by the sellers and purchasers of the stock of a Canadian company against the Province of Newfoundland and Labrador,
and the three highest officials of that province. While a suggestion of immunity filed by the State Department removed the individual defendants, the court dismissed the government defendants for lack of subject matter jurisdiction. After explaining that governments were not "persons" within the meaning of § 3(a)(9), the court observed:

... it is clear that Congress intended to exclude governments from its definition of "persons" in the 1934 Act. It is significant that the earlier Securities Act of 1933 defines 'person' as '... a government or political subdivision thereof.' 15 U.S.C. § 77b(2). The definition in the 1934 Act virtually parallels the language, with the important exception that governments are excluded. Congress obviously intended to exclude governments from liability for violation of the 1934 Act.

Id. at 90,227. According to the Greenspan court, the language of § 3(a)(9) is "clear and unambiguous" in not covering governments. Any other interpretation of § 3(a)(9) would contradict its plain meaning.

An identical interpretation of § 3(a)(9) was reached in In re Equity Funding Corp. of American Securities Litigation, 416 F. Supp. 161, 198 (D. Cal. 1976). There the plaintiffs asserted claims under § 10(b) against the States of California and Illinois and various state administrative agencies and officials. Those defendants were charged with aiding and abetting other defendants in the commission of securities fraud. After reaching the conclusion that the definition of person in
§ 3(a)(9) did not include states or their agencies, the court explained:

It could hardly be argued that 'aider and abettor' liability can be imposed under § 10(b) on entities not within the scope of principal liability under the statute, because not 'persons' under § 3(a)(9).

Id. at 198. The view of the Equity Funding court is unexceptional. The decisions in Greenspan and Equity Funding, as well as the court's reading of § 3(a)(9) in Monell, are in agreement with this court's view that the draftsmen of § 3(a)(9) did not intend to include governments -- municipal, state, federal or foreign -- within the definition of "person."

Finally, this court need not decide whether the 1975 Amendments had the effect of subjecting municipalities to the civil liability provisions of the 1934 Act. In fact, testimony before Congress a year later suggests that the 1975 Amendments were intended to resolve any question as to the SEC's authority to act with respect to governmental issuers. Cf. City of Philadelphia v. SEC, supra. It is significant that the same Congress that adopted the 1975 Amendments, one year later was unable to adopt -- or even report out of committee -- a bill that would have provided for express civil liability in connection with municipal securities. See, Municipal Securities Full Disclosure Act of 1976: Hearings Before the House of Representatives Subcommittee on Consumer Protection and Finance, supra. Congress apparently felt
that grave political and constitutional consequences flowed from subjecting the day to day conduct of municipal officials to the scrutiny of the federal securities laws. For example, exposing the mayor of a city to strict antifraud liability under § 10(b) for otherwise general remarks made during an after-dinner speech to constituents would be highly questionable, and would fundamentally alter the relationship between elected officials and the electorate. In my opinion, interjection of the federal securities laws into clearly political affairs of local government represents an unwarranted intrusion into the political life of the community.

Given the foregoing, the City of New York cannot be held liable under § 10(b) of the 1934 Act either as a principal or as an aider and abettor, and the complaints, to the extent they are based on § 10(b) are dismissed. Finally, since the complaints allege that Mayor Beame and Comptroller Goldin acted solely within their official capacities, they cannot be held individually liable under § 10(b), and the complaints as to them are dismissed.

III. § 17(a) Claim Against the City of New York

The plaintiffs argue that, even if § 10(b) does not apply to a municipality, a private cause of action against the City exists under § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a). To resolve this question, one must examine the statutory framework of the 1933 Act, the legislative history of § 17(a), and
the relevant law. See Cannon, supra, and Reddington, supra. Based on an analysis of those sources, I conclude that the plaintiffs' complaint against the City under § 17(a) must also be dismissed. (39)

Section 17(a) of the 1933 Act must be viewed together with the express civil liability provisions of § 11 and § 12(2) of the same Act. Section 11 only deals with noncompliance or faulty compliance with the registration and prospectus requirements of § 5. By contrast, § 12(2) of the 1933 Act, which expressly excludes exempted securities from its coverage, specifically provides a private remedy to a defrauded investor. Given the interrelationship of these sections, Congress probably did not intend § 17(a) to furnish defrauded investors with a further basis for asserting civil liability. See Douglas & Bates, Federal Securities Act, 43 Yale L.J. 171 (1934) ("Section 17 probably does not enlarge civil remedies of purchasers ... since Section 11 and 12 expressly state the remedies which are available"); 3 Loss, Securities Regulation 1785 (2d ed. 1966); Jennings & Marsh, Securities Regulation 863 (4th ed. 1977).

This interpretation of the structure of the 1933 Act, and the role of § 17(a) in that framework, is supported by its legislative history. First, the House Report on the 1933 Act clearly states under the heading, "Civil Liabilities" that "[S]ections 11 and 12 create and define the civil liabilities
imposed by the act and the machinery for their enforcement which renders them practically valuable." H.R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933). Nowhere in that discussion is § 17(a) mentioned. Second, § 17(a) appears to have been intended for a wholly different function, explained by one leading commentator as follows:

[A] reading of [$§ 17(a)$] in light of the entire Act leaves no doubt but that violations of its provisions give rise only to a liability to be restrained by injunctive action or, if willfully done, to a liability to be punished criminally."

Landis, Liability Sections of Securities Act, 18 American Accountant, 330, 331 (1933). The same view was expressed by Judge Friendly in SEC v. Texas Gulf & Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968), cert. denied sub nom. Coates v. SEC, 394 U.S. 976 (1969) (Friendly, J. concurring), where he observed that there was "unanimity among the commentators" that § 17(a) of the 1933 Act "was intended only to afford a basis for injunctive relief and, on a proper showing, for criminal liability . . . ." While the SEC has expressed the view that § 17(a) grants it the authority to investigate municipal issuers, see SEC Release No. 34-11875 (November 26, 1975); see generally n. 34, supra and accompanying text, neither the legislative history nor the statutory language of § 17(a) supports the implication of a private cause of action with respect to municipal issuers.

Plaintiffs urge that Kirchner v. U.S., 603 F.2d 234,
(2d Cir. 1978), cert. denied sub nom. Goldberg v. Kirshner, 48 U.S.L.W. 3383 (Dec. 10, 1979), rehearing denied, No. 77-6104 (2d Cir. July 18, 1979), has established a "naked § 17(a)" cause of action. See Wigand v. Flo-Tek, Inc., No. 79-7150 (2d Cir. October 19, 1979), as amended, No. 79-7150 (2d Cir. January 14, 1980). In Kirshner, the Court of Appeals for the Second Circuit recently held that the plaintiff, a beneficiary of a pension fund, could sue the trustees of that fund under both § 10(b) and § 17(a). In upholding the § 17(a) claim, the court noted that "there [is] little practical point in denying the existence of an action under § 17(a) once it is established that an aggrieved buyer has a private action under § 10(b) of the 1934 Act." Id. at 94,672, citing SEC v. Texas Gulf Sulphur Co., supra, at 867 (Friendly, J. concurring). However, since as I perceive it, Congress did not intend to confer a private cause of action under § 10(b) against a municipal issuer, see supra, n. 24 to 35 and accompanying text, Congress certainly did not intend to provide such a remedy under § 17(a) alone. Consequently, I deem it inappropriate to imply a private cause of action against municipal issuers under § 17(a).^{40}

The question being elsewhere undecided, and now squarely presented, I conclude for the reasons stated above that a private right of action against municipal issuers does not exist under § 17(a) of the 1933 Act, and the plaintiffs' claims against the City based thereon are dismissed.
IV. The Pendent State Law Claims

Notwithstanding that the plaintiffs' federal securities law claims against the City defendants must fail, the question remains as to whether there is pendent jurisdiction over the City defendants with respect to the plaintiffs' common law fraud claims. This raises the "subtle and complex" issue presented in Aldinger v. Howard, 427 U.S. 1 (1976), of "whether the doctrine of pendent jurisdiction extends to confer jurisdiction over a party as to whom no independent basis of federal jurisdiction exists." Id. at 2-3. I conclude that this court lacks the power in this case to adjudicate state law claims against a party not otherwise subject to federal jurisdiction.

In Aldinger, the plaintiff commenced an action in federal court against Spokane County and various county officials. In addition to a cause of action under Section 1983 of the Civil Rights Act of 1971, 42 U.S.C. § 1983, the complaint alleged common law tort claims. The Court held that since the county was not subject to suit under 42 U.S.C. § 1983, the state law claims would have to be dismissed as well. (41) The court pointed out that the parameters of the federal courts' subject matter jurisdiction are defined not only by the language of Article III of the Constitution, but by the "deductions which may be drawn from congressional statutes as to whether Congress
wanted to grant this sort of jurisdiction to federal courts." Id. at 17. Thus, great emphasis was placed on the fact that Congress had excluded counties from liability under § 1983 by not including them in the statute's definition of "persons":

Parties such as counties, whom Congress excluded from liability in § 1983, and thereby by reference in the grant of jurisdiction under § 1343(3), can argue with a great deal of force that the scope of that "civil action" over which the district courts have been given statutory jurisdiction should not be so broadly read as to bring them back within that power merely because the facts also give rise to an ordinary civil action against them under state law.

Id. at 17. In furtherance of this legislative intent, the Court concluded that the plaintiffs' state law claims against the county could not be joined with its federal claims against other parties. In essence, the Court held that pendent jurisdiction could not be used to bring local governments back into the very cases from which the substantive legislation had excluded them.

This analysis is obviously applicable here. As discussed earlier, Congress excluded cities from the scope of § 10(b) of the Exchange Act and Rule 10b-5. Section 27 of the Act confers jurisdiction over "... actions at law brought to enforce liability or duty created by this chapter or the rules and regulations thereunder." 15 U.S.C. § 78aa. The exclusion of cities from liability under the substantive provisions of the Act evidences a Congressional intent to withhold
federal court jurisdiction over actions for securities fraud under state law. I deem it inappropriate, given the principles of Aldinger, to hold the City defendants on a pendent jurisdiction theory in the very actions from which Congress has excluded them. Plaintiffs' state law claims against the City defendants are therefore dismissed.

Conclusion

The motion to dismiss by the underwriter and seller defendants is denied, and the motion to dismiss by the City of New York and its former Mayor and Comptroller is granted.

So ordered.


United States District Judge
Footnotes


(4) The City is a named defendant in Friedlander v. City of New York, supra; Spector v. City of New York, supra; Goldfarb v. City of New York, supra; Weisberg v. City of New York, supra; Manchester v. City of New York, supra.
(5) In one of these cases, World Airways, Inc. v. Salomon Brothers, 78 Civ. 0072 (S.D.N.Y. 1978), the plaintiff has advised the court that he will amend his complaint to join the City as a defendant if the instant motions are denied.

(6) Plaintiff World Airways has submitted a motion for partial summary judgment pursuant to Fed.R.Civ.P. 56(c). Argument on this motion has been deferred by the court until after decision on the motions to dismiss.

(7) Section 10(b) provides:

It shall be unlawful for any person, directly or indirectly, by 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.


(3) Rule 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 any facility of any national 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.

17 C.F.R. § 240.10b-5.
(9) Senate Report No. 792, 73rd Cong., 2d Sess. 14 (1934)


(12) Testimony before both the House and Senate Committees shows that the draftsmen of the Act believed that the Federal Trade Commission would take up the question of exempting municipal securities. See Hearings Before House of Representatives Committee on Interstate and Foreign Commerce on H.R. 7852 and H.R. 8720, 73rd Cong., 2d Sess. 813-24 (1934) ("House Hearings"); Stock Exchange Practice: Hearings Before the Senate Banking and Currency Committee on S. Res. 84 and S. Res. 66 and S. Res. 97, 73rd Cong., 2d Sess. 7476-75 (1934) ("Senate Hearings.").

(14) There were specific objections to the application to municipal securities of the proposed margin requirements, capital requirements for dealers, regulation of the over-the-counter market and prohibitions on market stabilization. See, e.g., Senate Hearings, supra, at 6839-40, 7058-9, 7432-4, 7441-3.

(15) Default had occurred in about $1,500,000,000 worth of bonds. This figure, while substantial in size, is somewhat deceptive. It represents the total dollar value of issues in which there had been some non-payment; any delinquency caused the entire debt of that issuer to be considered in default. See House Hearings, supra, at 822. Senate Hearings, supra, at 7443.


(17) Nothing in the legislative history of the 1934 Act suggests that § 10(b) was intended to include United States Treasury bonds but to exclude municipal securities.

(18) Section 12(2), 15 U.S.C. § 77a(2) provides:

Any person who --

(1) offers or sells a security in violation of 77e of this title, or
(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission) and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

(19) Section 3(a)(2), 15 U.S.C. § 77c(a)(2), which is almost identical to § 3(a)(12) of the 1934 Act, defines exempted securities as follows:

(a) Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities:

(2) Any security issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or territory, or by any public instrumentality of one or more States or territories, or by any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing; . . . ."

(20) The plaintiff purchaser suing under § 10(b), as opposed to § 12(2), avoids the restrictive provisions of the 1933 Act. Specifically, he circumvents the one year statute of limitation imposed by
§ 13 and the recission measure of damages provided in § 12(2). However, as discussed infra, the plaintiff-purchaser must bear the much heavier burden of proving scienter when suing under § 10(b), and he loses the advantage of the 1933 Act requirement that the defendant carry the burden of going forward with his "due diligence" defense. See Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). See generally, n. 23, supra.

(21) Thiele relied on the rationale of Kardon v. National Gypsum, 69 F. Supp. 512 (E.D. Pa. 1946) and Fischman v. Raytheon Manufacturing Co., 186 F.2d 783 (2d Cir. 1951), i.e., a tort theory of recovery, as a basis for implying a private cause of action under § 10(b). Defendants argue that recent decisions rejecting the Kardon-Fischman rationale effectively overrule Thiele and its progeny. However, given the Supreme Court's acknowledgment of the existence of § 17(b) cause of action, Cannon v. University of Chicago, supra, at 1955 n. 13, as well as the acceptance of the Kardon-Fischman rationale in Blue Chip Stamps, 421 U.S. 723 (1975), and Ernst & Ernst v. Hochfelder, supra, the defendant's position must be rejected. See, Ross v. A.H. Robbins, No. 79-7105, slip op. at 4811 (2d Cir. September 24, 1979)(a post-Cannon affirmation of the applicability of the Kardon-Fischman rationale in the context of § 10(b).

(22) Professor Loss points out the anomalies created by the implication of a private right of action under § 10(b), but fails to acknowledge the anomalies created by other possible interpretations. The Ninth Circuit in Ellis v. Carter, 291 F.2d 270, 272-74 (9th Cir.1961)
sets forth four possible constructions of § 10(b) and explains the
difficulties presented by each one:

(1) As permitting no civil actions to either buyer
or seller on the ground that the 1933 and 1934 acts were
too closely drafted to permit the inference of any private
remedies in addition to those expressly provided in sec-
tions 11 and 12 of the 1933 act, and sections 9(e), 16(b)
and 18(a) of the 1934 act. But under such a construction
defrauded sellers are given no civil remedy under either
act, which seems inconsistent with the all-embracing
scope of the legislation and requires that an unexplained
distinction be drawn between buyers and sellers.

(2) As permitting sellers but not buyers to sue
under the rule, thereby giving both buyers and sellers
a civil remedy but limiting that of buyers to the reme-
dies provided in the 1933 act. But this seems inconsis-
tent with the fact that section 10(b) and rule 10b-5 are
expressly applicable to buyers as well as sellers. More-
ever, there seems to be no good reason why Congress would
want to restrict buyers to the limited remedies provided
in the 1933 act, while giving sellers an unrestricted
civil remedy. The converse inference -- drawn by read-
ing the restrictions of the 1933 act which apply only
to buyers as applicable also to sellers under the 1934
act -- would constitute judicial rewriting which even
appellees concede would be too gross.

(3) As permitting buyers as well as sellers to sue
under the 1934 act, but to make buyers' actions there-
under subject to the same restrictions as provided for
them in the 1933 act. This avoids the anomaly of giv-
ing the buyer a less restricted remedy under the 1934
act than he has under the 1933 act. In effect, however,
it is the same as giving him no right under the 1934
act, leaving an unexplained distinction between buyers
and sellers as noted above.

(4) As permitting buyers as well as sellers to
sue under section 10(b) and rule 10b-5 without any dis-
tinction whatever, free of the restrictions imposed
under the 1933 act. This construction has the virtue
of giving both buyers and sellers a civil remedy and
giving buyers the same unrestricted remedy which is
given to sellers, no reason being shown why Congress
should have intended to treat them differently. But
this construction is saying in effect that the procedural
restrictions which Congress carefully provided in the
1933 act with regard to a buyer's civil remedy were
completely nullified or ignored by Congress a year later in giving buyers an unrestricted civil remedy.

In Matheson we adopted the fourth of these alternatives. We now adhere to that determination. Recognizing the anomaly inherent therein, as noted above, we consider it the most acceptable of the four possible alternatives. It gives controlling weight to what seems to have been the dominant policy of Congress to provide complete and effective sanctions, public and private, with respect to the duties and obligations imposed under the two acts. It requires no variance in procedures under the 1934 act as between buyer and seller, no reason appearing why Congress would have wanted the procedures to be different. While it assumes that Congress in 1934 undid what it carefully did in 1933, it avoids judicial rewriting of the 1934 act to include procedural provisions which appear only in the 1933 act. As between two acts which deal with the problem, it permits the most recent enactment to govern . . . ."

Although the court goes on to conclude that a cause of action under § 10(b) could be sustained without a showing of scienter, a view repudiated by the Supreme Court in Ernst & Ernst v. Hochfelder, supra, the conclusion that purchasers should be entitled to sue under § 10(b) is consistent in all other respects with decisions in this circuit. See, e.g., SEC v. Texas Gulf Sulphur, 401 F.2d 833, 864 (2d Cir. 1968), cert. denied sub nom. Coates v. SEC, 394 U.S. 976 (1969) (Friendly, J. concurring); Forman v. Community Services Inc., 500 F.2d 1246 (2d Cir. 1974) rev'd on other grounds sub nom. United Housing Foundation v. Forman, 421 U.S. 837 (1975). Cf. Weber v. C.W.P. Corp., 242 F. Supp. 321 (S.D.N.Y. 1965) (criticizing the Ellis court for not requiring scienter in § 10(b) actions).

Id. at 752 n. 15. Since Thiele the lower federal courts have unanimously recognized an implied cause of action under § 10(b) in favor of purchasers alleging fraud, as opposed to mere negligent misrepresentation, in the sale of securities. The Rosenberg decision, which denied the more liberal venue provision available under § 10(b) to a plaintiff whose allegations fell within the express provisions of the 1933 Act, has not been followed in this circuit. See generally 1 Bromberg, Securities Fraud § 2.42(2) n. 76 ("Rosenberg v. Globe Aircraft Corp. . . . can no longer be regarded as valid.") It is inconceivable that Congress intended to subject the defrauding party in the initial distribution to the recission measure of damages available under § 12(2) of the 1933 Act, while subjecting the wrongdoer in the aftermarket to the market measure of damages under § 10(b) of the 1934 Act.

(24) Although the plaintiffs and underwriter defendants argue that the term "corporation" in § 3(a)(9) covers municipal corporations, that position is wholly inconsistent with the legislative history of the 1934 Act. As discussed above, the draftsmen of the 1934 Act were extremely concerned with maintaining a balanced treatment of governmental entities. The statutory construction urged by these parties would impute
to Congress an intent to subject municipalities to § 10(b) liability, while simultaneously excluding states and the federal government from those provisions. This construction is simply unsupportable.

(25) By virtue of 17 C.F.R. § 240-01(b), the definition of "person" in § 3(a)(9) applies to Rule 10b-5, 17 C.F.R. § 240.10b-5.

(26) Section 17(a), 15 U.S.C. § 77q(a) is the only provision of the 1933 Act to which the § 3(a)(2) exemption for governmental issuers does not apply. It provides that:

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation in interstate commerce or by the use of the mails, directly or indirectly —

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser.

This section does no more than provide a basis for criminal prosecution and SEC injunctive proceedings. See discussion of § 17(a) infra. The constitutionality of SEC enforcement actions against municipal issuers pursuant to this section has not yet been conclusively established. See City of Philadelphia v. SEC, 434 F. Supp. 281 (E.D. Pa. 1977), appeal dismissed for want of jurisdiction, 434 U.S. 1003 (1973).
(27) See n. 10, supra.

(28) See text accompanying n. 8 to 17.


(30) The legislative history of the 1975 Amendments does not reveal what was on the minds of legislators in 1934. At best, it is evidence of what the 1975 Congress understood about the operation of the 1934 Act.


In 1976 Senatorator Williams introduced S. 2969 to resolve
the issue of civil liability of municipal issuers and underwriters. In his testimony on that bill, Professor Doty offered the following explanation of the effect (and purpose) of the 1975 Amendments:

It is important to realize that Rule 10b-5 became explicitly applicable to municipal securities issuers only last year. The Securities Acts Amendments of 1975 added to the definition of "person" a "government, or political subdivision, agency, or instrumentality of a government." This definition is incorporated into Rule 10b-5 by Commission Rule 0-1(b). The Commission evidently takes the position that this amendment was only for clarifying purposes, since it was ignored in Securities Exchange Act Release No. 11876 (November 26, 1975), in which the Commission referred to past applicability of Rule 10b-5.

This position may or may not be accurate. The Committee Report on S. 249 mentions the change as an amendment, but does not say it is only for clarification. S. Rep. No. 75, 94th Cong., 1st Sess. 90 (1975). For years, the definition of "person" included "corporations," but said nothing of "municipal corporations." This is significant. As indicated below in the discussion of sovereign immunity issues, the Supreme Court has required specific reference to state and local governments before holding them subject to other legislation.

Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs on S. 2969 and S. 2574, 94th Cong., 2d Sess., 311 (1976).

(34) A year after the passage of the 1975 Amendments there was still debate over whether those amendments did anything other than clarify the SEC's authority to investigate municipal issuers. See Hearings Before the Subcommittee on Consumer Protection and Finance of the House of Representatives Committee on Interstate and Foreign Commerce on H.R. 15205, H.R. 10523, H.R. 10530, H.R. 10606 and H.R. 11534,


(36) The Forman court did, however, reject the State's attempt to interpose the doctrine of sovereign immunity as a bar to a claim against it arising out of the sale of securities. 500 F.2d at 1256. The court supports its conclusion that New York State had waived its sovereign immunity by referring to the legislative history of the 1933 Act. 500 F.2d at 1257. The section referred to by the court, H.R. Rep. No. 85, 73rd Cong., 1st Sess. 11, merely noted that the term "person" in the 1933 Act is broad enough to embrace states and local governments and their instrumentalities. That section of the House Report has nothing whatsoever to do with the civil liability provisions of the 1933 Act, which expressly exclude governmental issuers. It was undoubtedly selected by the Forman court only to bolster its argument that, for certain purposes, Congress intended the regulatory scheme to include governmental issuers.
(37) Earlier decisions holding that § 10(b) applied to transactions in municipal securities did not consider whether § 3(a)(9) included state or local governments. For example, neither Baron v. Shields, supra or Thiele v. Shields, supra, even recite the definition of "person" in § 3(a)(9). Those cases cannot be said to have settled the meaning of "person" for § 10(b) purposes. Moreover, in Thiele, the governmental issuer was not a named defendant.

(38) The allegations in these complaints do not suggest that these individual defendants "acted either outside the scope of his respective office, or, if within the scope, acted in an arbitrary manner, grossly abusing the lawful power of his office." Scheuer v. Rhodes, 415 U.S. 232, 237 (1974).

(39) The text of § 17(a) of the 1933 Act is set forth in n. 25, supra.

This raises the difficult issue of whether it would be unconstitutional to limit the prerogatives of municipal officers by subjecting them to liability under § 10(b) with respect to statements made to the general public during a time of crisis. This court need not decide these constitutional questions since a statutory interpretation of § 10(b) requires dismissal of this action against the City defendants.

(41) In Aldinger, the Supreme Court followed Monroe v. Pape, 365 U.S. 167 (1961) which held that local governments were not "persons" subject to suit under § 1983. However, Monroe v. Pape was subsequently overruled by Monell v. New York Dept. of Social Services, 436 U.S. 658 (1978). In Monell, after reexamining the legislative history of § 1983, the Court concluded that Congress had intended to subject municipalities to suit under certain circumstances. This conclusion undermines the holding of Aldinger to the extent that municipalities are no longer wholly immune from suit under § 1983. Nevertheless, the validity of the holding in Aldinger as to pendent party jurisdiction remains intact. As the court stated in Owen Equipment & Erection Co. v. Kroger, 437 U.S. 365 (1978) "Monell in no way qualifies the holding of Aldinger that the jurisdictional questions presented in a case such as this one are statutory as well as constitutional . . . ." Id. at 372 n.12.

(42) The underwriter defendants rely on United Mine Workers v. Gibbs, 383 U.S. 715 (1966) in which the Supreme Court sanctioned the joinder of state and federal law claims when such are asserted against the same defendant. In Aldinger the Supreme Court made it very clear that the alignment of parties and claims before it, which are identical
to those in this case, was entirely different from that presented in Gibbs:

From a purely factual point of view, it is one thing to authorize two parties, already present in federal court by virtue of a case over which the court has jurisdiction, to litigate in addition to their federal claim a state-law claim over which there is no independent basis of federal jurisdiction. But it is quite another thing to permit a plaintiff, who has asserted a claim against one defendant with respect to which there is federal jurisdiction, to implead an entirely different defendant on the basis of a state-law claim over which there is no independent basis of federal jurisdiction, simply because his claim against the first defendant "and his claim against the second defendant "derive from a common nucleus of operative fact." 427 U.S. at 14.

(43) The underwriter defendants argue that the court should take into account the fact that the City defendants may be brought back into the case anyway on third-party claims for indemnity or contribution. See Owen Equipment & Erection Co. v. Kroger, 437 U.S. 365, 376 (1978). There are several obstacles to such impleader. First, indemnification is not available for underwriters in a securities fraud case. Stratton Group, Ltd. v. Sprayregen, 466 F. Supp. 1180, 1185 n.4 (S.D.N.Y. 1979), citing Globus v. Law Research Services, Inc., 418 F.2d 1276, 1288 (2d Cir.), cert. denied, 397 U.S. 913 (1970). Second, the underwriter defendants cannot seek contribution from the City defendants on the plaintiffs' federal securities fraud claims. This is because contribution may only be required of a joint tortfeasor, and the City defendants are not subject to liability under the antifraud provisions of the federal securities laws. Id. at 1185.
n. 6, 1186 n. 7.

Impleader of the City defendants could only be based on a cause of action for contribution as to the plaintiff's state law claims against the underwriter defendants. However, even on that theory, impleader of the City defendants might be precluded. Under Aldinger, "the posture in which the nonfederal claim is asserted and . . . the specific statute that confers jurisdiction over the federal claim" would have to be considered "to determine whether 'Congress in [that statute] has . . . expressly or by implication negated' the exercise of jurisdiction over the particular nonfederal claim. Aldinger v. Howard, supra, at 18." Oven Equipment & Erection Co. v. Kroger, 437 U.S. at 373. Even if the third party claim falls within the statutory jurisdiction of this court, the question would remain whether pendent party jurisdiction over the City should be retained as a matter of discretion. United Mine Workers v. Gibbs, 383 U.S. 715, 726 (1966).
We hold, rather, that the agency’s regulations implementing the statutory requirement of “an opportunity for a public hearing” under § 402 of the FWPCA are valid. Respondents have failed to demonstrate that those regulations were not applied properly in the context of this case. The Court of Appeals’ judgment reversing the case to the agency for an adjuditory hearing on the EPA’s extension of the expiration date of Los Angeles’ NPDES permit for its Hyperion Wastewater Treatment plant is reversed.

It is so ordered.

WILLIAM ALSUP, Assistant to the Solicitor General (WADE H. McCREE, JR., Solicitor General, JAMES W. MOORMAN, Assistant Attorney General, LOUIS F. CLAIBORNE, Deputy Solicitor General, ANGUS MACBETH and RAYMOND W. MUSHAL, Justice Department attorneys, JOAN Z. BERNSTEIN, General Counsel, WILLIAM F. PEDERSEN, Deputy General Counsel, and LISA K. FRIEDMAN, EPA attorney, with him on the brief) for petitioner; ROBERT K. BEST, SACRAMENTO, CALIF. (RONALD A. ZUMBRUN, and THOMAS E. HOOKANO, with him on the brief) for respondents.

No. 78-1202

Vincent F. Chierella, Petitioner, On Writ of Certiorari to the United States Court of Appeals for the Second Circuit.

March 18, 1980

Syllabus

Section 10 (b) of the Securities Exchange Act of 1934 (Act) prohibits the use “in connection with the purchase or sale of any security ... of any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe.” Rule 10b-5 of the Securities and Exchange Commission (SEC), promulgated thereunder, makes it unlawful for any person to “employ any device, scheme, or artifice to defraud,” or to “engage in any act, practice, or course of business which operate or would operate as a fraud or a deceit upon any person, in connection with the purchase or sale of any security.” Petitioner, who was employed by a financial printer that had been engaged by certain corporations to print corporate takeover bids, denied the names of the target companies from information contained in documents delivered to the printer by the acquiring companies and, without disclosing his knowledge, purchased stock in the target companies and sold the shares immediately after the takeover attempts were made public. After the SEC began an investigation of its trading activities, petitioner entered into a consent decree with the SEC in which he agreed to return his profits to the sellers of the shares. Thereafter, petitioner was indicted and convicted for violating § 10 (b) of the Act and SEC Rule 10b-5. The District Court’s charge permitted the jury to convict the petitioner if it found that he willfully failed to inform sellers of target company securities that he knew of a forthcoming takeover bid that would make their shares more valuable. Petitioner’s conviction was affirmed by the Court of Appeals.

 Held: Petitioner’s conduct did not constitute a violation of § 10 (b), and hence his conviction was improper.

(a) Administrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10 (b) despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure. However, such liability is premised upon a duty to disclose (such as that of a corporate insider to shareholders of the corporation) arising from a relationship of trust and confidence between parties to a transaction.

(b) Here, petitioner had no affirmative duty to disclose the information as to the plans of the acquiring companies. He was not a corporate insider, and he received no confidential information from the target companies. Nor could any duty arise from petitioner’s relationship with the sellers of the target companies’ securities, for he had no prior dealings with them, was not their agent, and was not a person in whom the sellers had placed their trust and confidence. A duty to disclose under § 10 (b) does not arise from the mere possession of nonpublic market information.

(c) This Court need not decide whether petitioner’s conviction can be supported on the alternative theory that he breached a duty to the acquiring corporation, since such theory was not submitted to the jury. 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 conviction cannot be affirmed on the basis of a theory not presented to the jury.

588 F. 2d 1355, reversed.

MR. JUSTICE POWELL delivered the opinion of the Court.

The question in this case is whether a person who learns from the confidential documents of one corporation that it is planning an attempt to secure control of a second corporation violates § 10 (b) of the Securities Exchange Act of 1934 if he fails to disclose the impending takeover before trading in the target company’s securities.

Petitioner is a printer by trade. In 1975 and 1976, he worked as a “mark-up man” in the New York composing room of Pandick Press, a financial printer. Among documents that petitioner handled were five announcements of corporate takeover bids. When these documents were delivered to the printer, the identities of the acquiring and target corporations were concealed by blank spaces or false names. The true names were sent to the printer on the night of the final printing.

The petitioner, however, was able to deduce the names of the target companies before the final printing from other information contained in the documents. Without disclosing his knowledge, petitioner purchased stock in the target companies and sold the shares immediately after the takeover attempts were made public. By this method, petitioner realized a gain of slightly more than $30,000 in the course of 14 months. Subsequently, the Securities and Exchange Commission (Commission or SEC) began an investigation of his trading activities. In May 1977, petitioner entered into a consent decree with the Commission in which he agreed to return his profits to the sellers of the shares. On the same day, he was discharged by Pandick Press.

In January 1978, petitioner was indicted on 17 counts of violating § 10 (b) of the Securities Exchange Act of 1934 (1934 Act) and SEC Rule 10b-5. After petitioner unsuccessfully moved to dismiss the indictment, he was brought to trial and convicted on all counts.

The Court of Appeals for the Second Circuit affirmed petitioner’s conviction. 588 F. 2d 1358 (1978). We granted certiorari, 441 U. S. 942 (1979), and we now reverse.

Section 10 (b) of the 1934 Act, 15 U. S. C. § 78j, prohibits the use “in connection with the purchase or sale of any sec-

Of the five transactions, four involved tender offers and one concerned a merger. United States v. Chierella, 588 F. 2d 1355, 1363, n. 2 (CA2 1978).

§ 32 (a) of the 1934 Act sanctions criminal penalties against anyone who willfully violates the Act. 15 U. S. C. § 78j (b) (1972-1978 Supp.). Petitioner was charged with 17 counts of violating the Act because he had received 17 letters confirming purchase of shares.

curity...[of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." Pursuant to this section, the SEC promulgated Rule 10b-5 which provides in pertinent part that:

"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.

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or a deceit upon any person, in connection with the purchase or sale of any security." 17 CFR § 240.10b-5 (1970).

This case concerns the legal effect of the petitioner's silence. The District Court's charge permitted the jury to convict the petitioner if it found that he willfully failed to inform sellers of target company securities that he knew of a forthcoming takeover bid that would make their shares more valuable. In order to decide whether silence in such circumstances violates §10 (b), it is necessary to review the language and legislative history of that statute as well as its interpretation by the Commission and the federal courts.

Although the starting point of our inquiry is the language of the statute, Ernst & Ernst v. Hochfelder, 425 U. S. 185, 197 (1976), § 10 (b) does not state whether silence may constitute a manipulative or deceptive device. Section 10 (b) was designed as a catch-all clause to prevent fraudulent practices. Id., at 202, 206. But neither the legislative history nor the statute itself affords specific guidance for the resolution of this case. When Rule 10b-5 was promulgated in 1942, the SEC did not discuss the possibility that failure to provide information might run afoul of § 10 (b).

The SEC took an important step in the development of § 10 (b) when it held that a broker-dealer and his firm violated that section by selling securities on the basis of undisclosed information obtained from a director of the issuer corporation who was also a registered representative of the brokerage firm. In Cody, Roberts & Co., 40 S. E. C. 907 (1961), the Commission decided that a corporate insider must abstain from trading in the shares of his corporation unless he has first disclosed all material inside information known to him. The obligation to disclose or abstain derives from

"[a]n affirmative duty to disclose material information[,] which has been traditionally imposed on corporate 'insiders,' particularly officers, directors, or controlling stockholders. We, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment." Id., at 911.

The Commission emphasized that the duty arose from (i) The existence of a relationship affording access to inside

5 Only Rules 10b-5 (a) and (c) are at issue here. Rule 10b-5 (b) provides that it shall be unlawful "(1) 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." 17 CFR §240.10b-5 (b) (1978). The portion of the indictment based on the provision was dismissed because the petitioner made no statements at all in connection with the purchase of stock.

6 Record at 962-963, 968.


information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure. Id., at 912. and n. 15.

That the relationship between a corporate insider and the stockholders of his corporation gives rise to a disclosure obligation is not a novel twist of the law. At common law, misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent. But one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information that "[t]he other [party] is entitled to know because of a fiduciary or similar relation of trust and confidence between them." In its Cody, Roberts decision, the Commission recognized a relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation. This relationship gives rise to a duty to disclose because of the "necessity of preventing a corporate insider from tak[ing] advantage of the uninformed minority stockholders." Speed v. Transamerica Corp., 99 F. Supp. 868, 892 (Del. 1951).

The Federal courts have found violations of §10 (b) where corporate insiders used undisclosed information for their own benefit. E. g., SEC v. Texas Gulf Sulphur Co., 401 F. 2d 833 (CA2 1968), cert. denied, 404 U. S. 1003 (1972). The cases also have emphasized, in accordance with the common-law rule, that "[t]he party charged with failing to disclose market information must be under a duty to disclose it." Fritson Corp. v. Financial Dynamics Fund, Inc., 534 F. 2d 273, 282 (CA2 1975). Accordingly, a purchaser of stock who has no duty to a prospective seller because he is neither

8 In Cody, Roberts, the broker-dealer was liable under § 10 (b) because it received actionable information from a corporate insider of the issuer. Since the insider could not use the information, neither could the partners in the brokerage firm with which he was associated. Cody, Roberts & Co., 40 S. E. C. 907 (1961). The transaction in Cody, Roberts involved sale of stock to persons who previously may not have been shareholders in the corporation, 1961, 79-1 CCH Fed. Sec. Rep. p (CCH 1964), at 931 and n. 2. The Commission embraced the reasoning of Judge Learned Hand that "the director or officer assumed a fiduciary relation to the buyer by the very sale; for it would be a sorry distraction to allow him to use the advantage of his position to induce the buyer into the position of a beneficiary although he was forbidden to do so once the buyer had become one." Id., at 914, n. 23, quoting Gratz v. Clashtong, 187 F. 2d 40, 49 (CA2 1951), cert. denied, 341 U. S. 929 (1951).


10 As regards securities transactions, the American Law Institute recommends that "silence when there is a duty to speak may be a fraudulent act." AII. Federal Securities Code § 202 (b) (Proposed Official Draft 1978).


The dissent of Mr. Justice Black suggests that the "special facts" doctrine may be applied to find that "silence constitutes fraud where one party has superior information to another. Post at 3. The Court has never so held. In String v. Repide, 213 U. S. 149, 143-144 (1909), this Court applied the "special facts" doctrine to enable a corporate insider to disclose to a shareholder. In that case, the majority shareholder of a corporation secretly purchased the stock of another shareholder without revealing that the corporation, under the insider's direction, was about to sell corporate assets at a price that would greatly enhance the value of the stock. The decision in String v. Repide was premised upon the fiduciary duty between the corporate insider and the shareholder. See Pepper v. latham, 306 U. S. 392, 367, n. 15 (1939).
Petitioner's use of that information was not a fraud under § 10 (b) unless he was subject to an affirmative duty to disclose it before trading. In this case, the jury instructions failed to specify any such duty. In effect, the trial court instructed the jury that petitioner owed a duty to everyone; to all sellers, indeed, to the market as a whole. The jury simply was told to decide whether petitioner used material, nonpublic information at a time when "he knew other people trading in the securities market did not have access to the same information." Record, at 677.

The Court of Appeals affirmed the conviction by holding that "[i]nfo...mate or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose." 588 F. 2d 1358, 1365 (CA2 1978) (emphasis in original). Although the court said that its test would include only persons who regularly receive material nonpublic information, id., at 1366, its rationale for that limitation is unrelated to the existence of a duty to disclose. The Court of Appeals, like the trial court, failed to identify a relationship between petitioner and the sellers that could give rise to a duty. Its decision thus rested solely upon its belief that federal securities laws have "created a system providing equal access to information necessary for reasoned and intelligent investment decisions." 588 F. 2d, at 1362. The use by anyone of material information not generally available is fraudulent, this theory suggests, because such information gives certain buyers or sellers an unfair advantage over less informed buyers and sellers.

This reasoning suffers from two defects. First, not every instance of financial unfairness constitutes fraudulent activity under § 10 (b). See Santa Fe Industries Inc. v. Green, 430 U. S. 462, 474-477 (1977). Second, 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 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.

We cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information. Formulation of such a broad duty, which would require a delicate balancing of interests, is appropriate to Dischee Market Information, 121 L. Pa. L. Rev. 798, 799 (1973).

11 The Court of Appeals said that its "regular access to market information" test would create a "workable rule embracing those who occupy . . . strategic places in the market mechanisms." United States v. Chiarella, 588 F. 2d 1358, 1365 (CA2 1978). These considerations are insufficient to support a duty to disclose. A duty arises from the relationship between parties, see nn. 9 and 10, supra, and accompanying text, and not merely from one's ability to acquire information because of his position in the market.

The Court of Appeals also suggested that the acquiring corporation itself would not be a "market insider" because a tender offeror creates, rather than receives, information and takes a substantial economic risk that its offer will be unsuccessful. Id., at 1360-1367. Again, the Court of Appeals departed from the analysis appropriate to recognition of a duty. The Court of Appeals for the Second Circuit previously held, in a manner consistent with our analysis here, that a tender offeror does not violate § 10 (b) when it makes a announcement purchases slightly because there is no relationship between the offeror and the seller:

"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." General Time Corp. v. Taylor Industries, 465 F. 2d 159, 194 (CA2 1972), reh. denied, 409 U. S. 1026 (1972).
departs radically from the established doctrine that duty arises from a specific relationship between two parties, see n. 9, supra, should not be undertaken absent some explicit evidence of congressional intent.

As we have seen, no such evidence emerges from the language or legislative history of § 10 (b). Moreover, neither the Congress nor the Commission ever has adopted a parity-of-information rule. Instead the problems caused by misuse of market information have been addressed by detailed and sophisticated regulation that recognizes when use of market information may not harm operation of the securities markets. For example, the Williams Act 16 limits but does not completely prohibit a tender offeror’s purchases of target corporation stock before public announcement of the offer. Congress’ careful action in this and other areas 18 contrasts, and is in some tension, with the broad rule of liability we are asked to adopt in this case.

Indeed, the theory upon which the petitioner was convicted is at odds with the Commission’s view of § 10 (b) as applied to activity that has the same effect on sellers as the petitioner’s purchases. “Warehousing” takes place when a corporation gives advance notice of its intention to launch a tender offer to institutional investors who then are able to purchase stock in the target company before the tender offer is made public and the price of shares rises. 19 In this case, as in warehousing, a buyer of securities purchases stock in a target corporation on the basis of market information which is unknown to the seller. In both of these situations, the seller’s behavior presumably would be altered if he had the nonpublic information. Significantly, however, the Commission has acted to bar warehousing under its authority to regulate tender offers 20 after recognizing that action under § 10 (b) would rest on a “somewhat different theory” than that previously used to regulate insider trading as fraudulent activity. 21

We see no basis for applying such a new and different theory of liability in this case. As we have emphasized before, the 1934 Act cannot be read “more broadly than its language and the statutory scheme reasonably permit.” 22 Toche Ross & Co. v. Redington, 47 U. S. L. W. 4733, 4735 (June 18, 1979), quoting SEC v. Sloan, 436 U. S. 103, 116 (1978). Section

15 U. S. C. § 78m (d)(1) permits a tender offeror to purchase 5% of the target company’s stock prior to disclosure of its plans for acquisition.


17 Fletcher, Moundheim & Murphy, supra n. 10, at 811-812.


20 (b) is aptly described as a catch-all provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under § 10 (b) does not arise from the mere possession of nonpublic market information. The contrary result is without support in the legislative history of § 10 (b) and would be inconsistent with the careful plan that Congress has enacted for regulation of the securities markets. Cf. Santa Fe Industries Inc. v. Green, 430 U. S., at 470.

IV

In its brief to this Court, the United States offers an alternative theory to support petitioner’s conviction. It argues that petitioner breached a duty to the acquiring corporation when he acted upon information that he obtained by virtue of his position as an employee of a printer employed by the corporation. The breach of this duty is said to support a conviction under § 10 (b) for fraud perpetrated upon both the acquiring corporation and the sellers.

We need not decide whether this theory has merit for it was not submitted to the jury. The jury was told, in the language of Rule 10b-5, that it could convict the petitioner if it concluded that he either (i) employed a device, scheme or artifice to defraud or (ii) engaged in an act, practice, or course of business which operated or would operate as a fraud or deceit upon any person. Record, at 681. The trial judge stated that “a scheme to defraud” is a plan to obtain money by trick or deceit and that “a failure by Chiarella to disclose material, non-public information in connection with his purchase of stock would constitute deceit.” Id., at 683. Accordingly, the jury was instructed that the petitioner employed a scheme to defraud if he “did not disclose . . . material non-public information in connection with the purchases of the stock.” Id., at 685-686.

Alternatively, the jury was instructed that it could convict if “Chiarella’s alleged conduct of having purchased securities without disclosing material, non-public information would have or did have the effect of operating as a fraud upon a seller.” Id., at 686. The judge earlier had stated that fraud “embraces all the means which human ingenuity can devise and which are resorted to by one individual to gain an advantage over another by false misrepresentation, suggestions or by suppression of the truth.” Id., at 683.

The jury instructions demonstrate that petitioner was convicted merely because of his failure to disclose material, non-

23 Mr. Justice Blackmun’s dissent would establish the following standard for imposing criminal and civil liability under § 10 (b) and Rule 10b-5: “Persons having access to confidential material information that is not legally available to others generally are prohibited from engaging in schemes to exploit their structural information advantage through trading in affected securities.” Post, at 7. This view is not substantially different from the Court of Appeals theory that anyone “who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose.” supra, at 9, quoting 688 F. 2d, at 1363, and must be rejected for the reasons stated in Part III. Additionally, a judicial holding that certain undefined activities “generally are prohibited” by § 10 (b) would raise questions whether either criminal or civil defendants would be given fair notice that they have engaged in illegal activity. Cf. Grayned v. City of Rockford, 408 U. S. 104, 108-109 (1972).

It is worth noting that this is apparently the first case in which criminal liability has been imposed upon a purchaser for § 10 (b) nondisclosure. Petitioner was sentenced to a year in prison, suspended except for one month, and a five-year term of probation. Id., at 1373, 1378 (Mebill, J., dissenting).
public 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. Because we cannot affirm a criminal conviction on the basis of the theory not presented to the jury, *Revis v. United States*, 401 U.S. 808, 814 (1971), see *Dunn v. United States*, 47 USLW 4607, 4609 (June 4, 1979), we will not speculate upon whether such a duty exists, whether it has been breached, or whether such a breach constitutes a violation of §10(b).  

The judgment of the Court of Appeals is reversed.

MR. JUSTICE STEVENS, concurring.

Before liability, civil or criminal, may be imposed for a Rule 10b-5 violation, it is necessary to identify the duty that the defendant has breached. Arguably, when petitioner bought securities in the open market, he violated (a) a duty to disclose to the sellers from whom he purchased target company stock and (b) a duty of silence owed to the acquiring companies. I agree with the Court’s determination that petitioner owed no duty of disclosure to the sellers, that his conviction rested on the erroneous premise that he did owe them such a duty, and that the judgment of the Court of Appeals must therefore be reversed.

The Court correctly does not address the second question: whether the petitioner’s breach of his duty of silence—a duty he unquestionably owed to his employer and to his employer’s customers—could give rise to criminal liability under Rule 10b-5. Respectable arguments could be made in support of either position. On the one hand, if we assume that petitioner breached a duty to the acquiring companies that had entrusted confidential information to his employers, a legitimate argument could be made that his actions constituted “a fraud or a deceit” upon those companies “in connection with the purchase or sale of any security.” On the other hand, inasmuch as those companies would not be able to recover damages from petitioner for violating Rule 10b-5 because they were neither purchasers nor sellers of target company securities, *see Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, it could also be argued that no actionable violation of Rule 10b-5 had occurred. I think the Court wisely leaves the resolution of this issue for another day.

I write simply to emphasize the fact that we have not necessarily placed any stamp of approval on what this petitioner did, nor have we held that similar actions must be considered lawful in the future. Rather, we have merely held that petitioner’s criminal conviction cannot rest on the theory that he breached a duty he did not owe.

I join the Court’s opinion.

MR. JUSTICE BRENNAN, concurring in the judgment.

The Court holds, correctly in my view, that “a duty to disclose under §10(b) does not arise from the mere possession of nonpublic market information.” *Ante*, at 12. Prior to so holding, however, it suggests that no violation of §10(b) could be made out absent a breach of some duty arising out of a fiduciary relationship between buyer and seller. I cannot subscribe to that suggestion. On the contrary, it seems to me that Part I of the Chief Justice’s dissent, *post*, at 1—4, correctly states the applicable substantive law—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.

While I agree with Part I of the Chief Justice’s dissent, I am unable to agree with Part II. Rather, I concur in the judgment of the majority because I think it clear that the legal theory sketched by the Chief Justice is not the one presented to the jury. As I read them, the instructions in effect permitted the jurors to return a verdict of guilty merely upon a finding of failure to disclose material nonpublic information in connection with the purchase of stock. I can find no instruction suggesting that one element of the offense was the improper conversion or misappropriation of that nonpublic information. Ambiguous suggestions in the indictment and the prosecutor’s opening and closing remarks are no substitute for the proper instructions. And neither reference to the harmless error doctrine nor some post hoc theory of constructive stipulation can cure the defect. The simple fact is that to affirm the conviction without an adequate instruction would be tantamount to directing a verdict of guilty, and that we plainly may not do.

MR. CHIEF JUSTICE BURGER, dissenting.

I believe that the jury instructions in this case properly charged a violation of §10b and Rule 10b-5, and I would affirm the conviction.

As a general rule, neither party to an arm’s length business transaction has an obligation to disclose information to the other unless the parties stand in some confidential or fiduciary relationship. See *Prosser, The Law of Torts* §106. This rule permits a businessman to capitalize on his experience and skill in securing and evaluating relevant information; it provides incentive for hard work, careful analysis, and astute forecasting. But the policies that underlie the rule also should limit its scope. In particular, the rule should give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means. One commentator has written:

"[T]he way in which the buyer acquires the information which he conceals from the vendor should be a material..."
circumstance. The information might have been acquired as the result of his bringing to bear a superior knowledge, intelligence, skill or technical judgment; it might have been acquired by chance; or it might be acquired by means of some tortious action on his part. ... Any time information is acquired by an illegal act it would seem that there should be a duty to disclose that information.” Kreton, Fraud—Concealment and Non-Disclosure, 15 Tex. L. Rev. 1, 23-26 (1936) (emphasis added).

I would read § 10b and Rule 10b-5 to encompass and build on this principle: to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading.

The language of § 10b and of Rule 10b-5 plainly support such a reading. By their terms, these provisions reach any person engaged in any fraudulent scheme. This broad language negates the suggestion that congressional concern was limited to trading by “corporate insiders” or to deceptive practices related to “corporate information.” Just as surely Congress cannot have intended one standard of fair dealing for “white collar” insiders and another for the “blue collar” level.

The very language of § 10b and Rule 10b-5 “by repeated use of the word ‘any’ [was] obviously meant to be inclusive.” Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972).

The history of the statute and of the rule also support this reading. The anti-fraud provisions were designed in large measure “to assure that dealing in securities is fair and without undue preferences or advantages among investors.” H.R. Conf. Rep. No. 94-229, 94th Cong., 1st Sess., 91-92 (1975). These provisions prohibit “those manipulative and deceptive practices which have been demonstrated to fulfill no useful function.” S. Rep. No. 792, 73d Cong., 2d Sess., 8 (1934).

An investor who purchases securities on the basis of misappropriated nonpublic information possesses just such an “undue” trading advantage; his conduct quite clearly serves no useful function except his own enrichment at the expense of others.

This interpretation of § 10b and Rule 10b-5 is in no sense novel. It follows naturally from legal principles enunciated by the Securities and Exchange Commission in its seminal case, Cadle, Roberts decision. 40 S. E. C. 907 (1961). There, the Commission relied upon two factors to impose a duty to disclose on corporate insiders: (1) “... access to information ... intended to be available only for a corporate purpose and not for the personal benefit of anyone” (emphasis added); and (2) the unfairness inherent in trading on such information when it is inaccessible to those with whom one is dealing. Both of these factors are present whenever a party gains an informational advantage by unlawful means. Indeed, in In re Blyth & Co., 43 S. E. C. 1037 (1969), the Commission applied its Cadle, Roberts decision in just such a context.

that case a broker dealer had traded in Government securities on the basis of confidential Treasury Department information which it received from a Federal Reserve Bank employee. The Commission ruled that the trading was “improper use of inside information” violative of § 10b and Rule 10b-5. Id., at 1040. It did not hesitate to extend Cadle, Roberts to reach a “tipper” of a Government insider.

Finally, it bears emphasis that this reading of § 10b and Rule 10b-5 would not threaten legitimate business practices. So read, the anti-fraud provisions would not impose a duty on a tender offeror to disclose its acquisition plans during the period in which it “tests the water” prior to purchasing a full 5% of the target company’s stock. Nor would it prohibit “warehousing.” See generally 4 SEC, Institutional Investor Study Report, H. R. Doc. 92-34, 92d Cong., 1st Sess., 2973 (1971). Likewise, market specialists would not be subject to a disclose-or-refrain requirement in the performance of their everyday market functions. In each of these instances, trading is accomplished on the basis of material nonpublic information, but the information has not been unlawfully converted for personal gain.

II

The Court’s opinion, as I read it, leaves open the question whether § 10b and Rule 10b-5 prohibit trading on misappropriated nonpublic information. Instead, the Court apparently concludes that this theory of the case was not submitted to the jury. In the Court’s view, the instructions given the jury were premised on the erroneous notion that the mere failure to disclose nonpublic information, however acquired, is a deceptive practice. And because of this premise, the jury was not instructed that the means by which Chiarrella acquired his informational advantage—by violating a duty owed to the acquiring companies—was an element of the offense. See ante, at 13.

The Court’s reading of the District Court’s charge is unduly restrictive. Fairly read as a whole and in the context of the trial, the instructions required the jury to find that Chiarrella, obtained his trading advantage by misappropriating the property of his employer’s customers. The jury was charged that “[i]n simple terms, the charge is that Chiarrella wrongfully took advantage of information he acquired in the course of his confidential position at Hardick Press and secretly used that information when he knew other people trading in the securities market did not have access to the same information that he had at a time when he knew that information was material to the value of the stock.” Record, at 477 (emphasis added).

The language parallels that in the indictment, and the jury had that indictment during its deliberations; it charged

---

1. Academic writing in recent years has distinguished between “corporate information”—information which comes from within the corporation and reflects on expected earnings or assets—and “market information.” See, e.g., Fiescher, Mundheim, & Murphy, An Initial Inquiry into the Responsibility to Disclose Market Information, 121 U. Pa. L. Rev. 785, 789 (1973). It is clear that the § 10b and Rule 10b-5 by their terms and by their history make two such distinction. See Bradley, Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws, 93 Harv. L. Rev. 322, 329-333 (1970).

2. See Financial Analysts Rec., Oct. 7, 1968, at 3, 5 (interview with SEC Commissioner Philip A. Loonis, Jr.) (the essential characteristic of insider information is that it is “received in confidence for a purpose other than to use it for the person’s own advantage and to the disadvantage of the investing public in the market”). See also Note, The Government Insider and Rule 10b-5, 47 Cal. L. Rev. 1461, 1468-1469 (1974).

*This interpretation of the anti-fraud provision also finds support in the recently proposed Federal Securities Code prepared by the American Law Institute under the direction of Professor Louis Loss. The ALI code would reverse the anti-fraud provision to cover a class of “quasi-insiders,” including a judge’s law clerk who trades on information in an unpublished opinion or a Government employee who trades on a secret report. See ALI Federal Securities Code § 1003, comment 3 (d), at 582-583. These quasi-insiders share the characteristic that their informational advantage is obtained by conversion and not by legitimate economic activity that society seeks to encourage.

*There is some language in the Court’s opinion to suggest that only a “relationship between petitioner and the seller ... could give rise to a duty [to disclose].” Ante, at 9. The Court’s holding, however, is much more limited, namely that mere possession of material nonpublic information is insufficient to create a duty to disclose or to refrain from trading. Ante, at 12. Accordingly, it is my understanding that the Court has not rejected the view, advanced above, that an absolute duty to disclose or refrain arises from the very act of misappropriating nonpublic information.
"that Chiarella had traded "without disclosing material non-
public information he had obtained in connection with his
employment." It is underscored by the clarity which the
prosecutor exhibited in his opening statement to the jury.
No juror could possibly have failed to understand what the case
was about after the prosecutor said: "In sum what the indi-
ment charges is that Chiarella misused material non-public
information for personal gain and that he took advantage of
his position of trust with full knowledge that it was wrong.
That is what the case is about. It is that simple." R. 49.
(Emphasis added.) Moreover, experienced defense counsel
took no exception and uttered no complaint that the instruc-
tions were inadequate in this regard.

In any event, even assuming the instructions were deficient in
not charging misappropriation with sufficient precision, on this
record that error was harmless beyond a reasonable doubt.
Here, Chiarella, himself, testified that he obtained his infor-
mational advantage by dealing confidential material en-
trusted to his employer by its customers. R. 474. He ad-
mitted that the information he traded on was "confidential,"
not "to be useful for personal gain." R. 490. In light of this
testimony, it is simply inconceivable to me that any
shortcoming in the instructions could have "possibly influ-
enced the jury adversely to [the defendant]." Chapman v.
California, 380 U. S. 18, 23 (1967). See also United States v.
Parr, 221 U. S. 658, 673-676. Even more telling perhaps is
Chiarella's counsel's statement in closing argument:

"Let me say right up front, too, Mr. Chiarella got on the
stand and he conceded, he said candidly, he used clues I
got while I was at work. I looked at these various docu-
ments and I deciphered them and I decoded them and I
used that information as a basis for purchasing stock." There
is no question about that. We don't have to go through a
halfbaked about that. It is something he

In this Court, counsel similarly conceded that "[w]e do not
dispute the proposition that Chiarella violated his duty as an
agent of the offeror corporations not to use their confidential
information for personal profit." Reply Brief at 4 (emphasis
added). See Restatement (Second) of Agency § 303 (1938).
These statements are tantamount to a formal stipulation that
Chiarella's informational advantage was unlawfully obtained.
And it is established law that a stipulation related to an essen-
tial element of a crime must be regarded by the jury as a
fact conclusively proved. See, e.g., Wimber, Evidence § 2560
(McNaughton rev. 1991); United States v. Houston, 547 F.
2d 104 (CA9 1976).

In sum, the evidence shows beyond all doubt that Chiarella,
working literally in the shadows of the warning signs in the
print shop, misappropriated—stole to put it bluntly—valuable
nonpublic information entrusted in him in the utmost con-

MR. JUSTICE BLACKMUN, with whom MR. JUSTICE MARSHALL
joins, dissenting.

Although I agree with much of what is said in Part I of the
dissenting opinion of THE CHIEF JUSTICE, ante, I write sepa-
rately because, in my view, it is unnecessary to rest petition-
er's conviction on a "misappropriation" theory. The fact
that petitioner Chiarella purloined, or, to use THE CHIEF
JUSTICE's word, ante, p. 7, "stole," information concerning
spending tender offers certainly is the most dramatic evidence
that petitioner was guilty of fraud. He has conceded that he
knew it was wrong, and he and his co-workers in the print
shop were specifically warned by their employer that actions
of this kind were improper and forbidden. But I also would
find petitioner's conduct fraudulent within the meaning of
§ 78j (b), and the Securities and Exchange Commission's Rule
10b-5, 17 CFR § 240.10b-5 (1979), even if he had obtained
the blessing of his employer's principals before embarking on
his profiteering scheme. Indeed, I think petitioner's brand
of manipulative trading, with or without such approval, lies
close to the heart of what the securities laws are intended
to prohibit.

The Court continues to pursue a course, charted in certain
recent decisions, designed to transform § 10 (b) from an inten-
tionally elastic "catchall" provision to one that catches rela-
tively little of the misbehavior that all too often makes
investment in securities a needlessly risky business for the
uninitiated investor. See, e.g., Ernst & Ernst v. Hochfelder,
425 U. S. 185 (1976); Blue Chip Stamps v. Manor Drug
Stores, 421 U. S. 723 (1975). Such confinement in this case
is now achieved by imposition of a requirement of a "special
relationship" akin to fiduciary duty before the statute gives
rise to a duty to disclose or to abstain from trading upon
material nonpublic information. The Court admits that this
conclusion finds no mandate in the language of the statute
or its legislative history. Ante, at 3. Yet the Court fails even
to attempt a justification of its ruling in terms of the pur-
poses of the securities laws, or to square that ruling with the
long-standing but now much-abused principle that the federal
securities laws are to be construed flexibly rather than with
narrow technicality. See Affiliated Ute Citizens v. United
States, 406 U. S. 128, 151 (1972); Superintendent of Insur-
ance v. Bankers Life & Casualty Co., 404 U. S. 6, 12 (1971); SEC

I, of course, agree with the Court that a relationship of
trust can establish a duty to disclose under § 10 (b) and
Rule 10b-5. But I do not agree that a failure to disclose
violates the Rule only when the responsibilities of a rela-
tionship of that kind have been breached. As applied to this
case, the Court's approach unduly minimizes the importanc
of petitioner's access to confidential information that the honest
investor, no matter how diligently he tried, could not legally
obtain. In doing so, it further advances an interpretation of
§ 10 (b) and Rule 10b-5 that stops short of their full implica-
tions. Although the Court draws support for its position
from certain precedent, I find its decision neither fully consist-
ent with developments in the common law of fraud, nor fully
in step with administrative and judicial application of Rule
10b-5 to "insider" trading.

The common law of actionable misrepresentation long has
treated the possession of "special facts" as a key ingredient in
the duty to disclose. See Strong v. Repide, 213 U. S. 419,
431-433 (1910); E. Harper & F. James, The Law of Torts
§ 7.14 (1956). Traditionally, this fact has been prominent
in cases involving confidential or fiduciary relations, where one
party's inferiority of knowledge and dependence upon fair
trading is a matter of legal definition, as well as in cases

* The Court fails to specify whether the obligations of a special relationship must flow directly upon the person engaging in an allegedly fraudulent transaction, or whether the derivative obligations of "tipping," that lower courts long have recognized, are encompassed by its rule. See ante, at 7, n. 12; cf. Fennoh-McKeehan, Inc. v. Prudential Securities Co., 423 U. S. 222, 255, n. 29 (1976).
where one party is on notice that the other is "acting under a mistaken belief with respect to a material fact." Frigifemp Corp. v. Financial Dynamics Fund, Inc., 524 F. 2d 275, 283 (CA2 1975); see also Restatement (First) of Torts § 551. Even at common law, however, there has been a trend away from strict adherence to the harsh maxim caveat emptor and toward a more flexible, less formalistic understanding of the duty to disclose. See, e.g., Keeton, Fraud—Concealment and Nondisclosure, 15 Tex. L. Rev. 1, 31 (1936). Steps have been taken toward application of the "special facts" doctrine in a broader array of contexts where one party's superior knowledge of essential facts renders a transaction without disclosure inherently unfair. See James & Gray, Misrepresentation—Part II, 57 Md. L. Rev. 488, 520-527 (1978); 3 Restatement (Second) of Torts § 551 (e). Comment l (1977); id., Tent. Draft No. 10, at 169-167 (1964). See also Lingssch v. Savage, 213 Cal. App. 2d 729, 735-737, 29 Cal. Rptr. 201, 204-206 (1963); Jenkins v. McCormick, 184 Kan. 842, 844-845, 339 P. 2d 8, 11 (1959); Jones v. Arnold, 359 Mo. 161, 169-170, 221 S. W. 2d 187, 193-194 (1949); Simmons v. Evans, 185 Tenn. 282, 285-287, 206 S. W. 2d 295, 298-299 (1947).

By its narrow construction of § 10 (b) and Rule 10b-5, the Court places the federal securities laws in the rear guard of this movement, a position opposite to the expectations of Congress at the time the securities laws were enacted. Cf. H. R. Rep. No. 1383, 73d Cong., 2d Sess. 5 (1934). I cannot agree that the statute and Rule are so limited. The Court has observed that the securities laws were not intended to replicate the law of fiduciary relations. Santa Fe Industries, Inc. v. Green, 430 U.S. 594, 492, 474-476 (1977). Rather, their purpose is to ensure the fair and honest functioning of impersonal national securities markets where common-law protections have proved inadequate. Cf. United States v. Naftalin, 441 U. S. 768, 775 (1979). As Congress itself has recognized, it is integral to this purpose "to assure that dealing in securities is fair and without undue preferences or advantages among investors." H. R. Conf. Rep. No. 94-229, p. 91 (1975).

Indeed, the importance of access to "special facts" has been a recurrent theme in administrative and judicial application of Rule 10b-5 to insider trading. Both the SEC and the courts have stressed the insider's misuse of secret knowledge as the gravamen of illegal conduct. The Court, I think, unduly minimizes this aspect of prior decisions.

Cody, Roberts & Co., 40 S. E. C. 907 (1961), which the Court discusses at some length, provides an illustration. In that case, the Commission defined the category of "insiders" subject to a disclose-or-abstain obligation according to two factors: "[F]irst, 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, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing." Id., at 912 (footnote omitted).

The Commission, thus, regarded the insider "relationship" primarily in terms of access to nonpublic information, and not merely in terms of the presence of a common-law fiduciary duty or the like. This approach was deemed to be in keeping with the principle that "the broad language of the anti-fraud provisions" should not be "circumscribed by fine distinctions and rigid classifications," such as those that prevailed under the common law. Ibid. The duty to abstain or disclose arose, not merely as an incident of fiduciary responsibility, but as a result of the "inherent unfairness" of turning secret information to account for personal profit. This understanding of Rule 10b-5 was reinforced when Investors Management Co., 44 S. E. C. 633, 643 (1971), specifically rejected the contention that a "special relationship" between the alleged violator and an "insider" source was a necessary requirement for liability.

A similar approach has been followed by the courts. In SEC v. Texas Gulf Sulphur Co., 401 F. 2d 833, 848 (CA2 1968) (en banc), cert. denied, 394 U. S. 976 (1969), the court specifically mentioned the common law "special facts" doctrine as one source for Rule 10b-5, and it reasoned that the rule 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." See also Lewelling v. First California Co., 564 F. 2d 1277, 1280 (CA9 1977); Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (Del. 1951). In addition, cases such as Mgel v. Fields, 386 F. 2d 718, 739 (CA9 1967), cert. denied, 396 U. S. 851 (1969) and A. T. Brod & Co. v. Perlow, 375 F. 2d 393, 397 (CA2 1967), have stressed that § 10 (b) and Rule 10b-5 apply to any kind of fraud by any person. The concept of the "insider" itself has been flexible; wherever confidential information has been abused, prophylaxis has followed. See, e.g., Zweig v. Hearst Corp., 594 F. 2d 1261 (CA9 1979) (financial columnist); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 405 F. 2d 228 (CA2 1967) (institutional investor); SEC v. Shapiro, 404 F. 2d 1301 (CA2 1974) (merger negotiator); Charles v. Smith, Barney & Co., 438 F. 2d 1187 (CA2 1970) (market maker). See generally A. Bromberg, Securities Law: Fraud § 7.4 (6) (b) (1975).

I believe, and surely thought, that this broad understanding of the duty of disclosure under Rule 10b-5 was recognized and approved in Affiliated Ute Citizens v. United States, 406 U. S. 128 (1972). That case held that bank agents dealing in the stock of a Ute Indian development corporation had a duty to reveal to mixed-blood Indian customers that their shares could bring a higher price on a non-Indian market of which the sellers were unaware. Id., at 150-153. The Court recognized that "by repeated use of the word 'any,' the statute and rule "are obviously meant to be inclusive." Id., at 151. Although it found a relationship of trust between the agents and the Indian sellers, the Court also clearly established that the bank and its agents were subject to the strictures of Rule 10b-5 because of their strategic position in the marketplace. The Indian sellers had no knowledge of the non-Indian market. The bank agents, in contrast, had intimate familiarity with the non-Indian market, which they could have promoted actively, and from which they and their bank both profited. In these circumstances, the Court held that if the bank and its agents "possessed the affirmative duty under the Rule" to disclose market information to the Indian sellers, and that the latter "had the right to know" that their shares would sell for a higher price in another market. Id., at 153.

It seems to me that the Court, ante, at 6, gives Affiliated Ute Citizens an unduly narrow interpretation. As I now read my opinion there for the Court, it lends strong support to the principle that a structural disparity in access to material information is a critical factor under Rule 10b-5 in establishing a duty either to disclose the information or to abstain from trading. Given the factual posture of the case, it was unnecessary to resolve the question whether such a structural disparity could sustain a duty to disclose even absent "a relationship of trust and confidence between parties to a transaction." Ante, at 7. Nevertheless, I think the rationale of
Affiliated Ute Citizens definitely points toward an affirmative answer to that question. Although I am not sure I fully accept the "market insider" category created by the Court of Appeals, I would hold that persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities. To hold otherwise, it seems to me, is to tolerate a wide range of manipulative and deceitful behavior. See Blyth & Co., 43 S. E. C. 1037 (1969); Herbert L. Hovenkamp, 13 S. E. C. 754 (1943); see generally Bruhney, Insiders, Outsiders and Informational Advantages under the Federal Securities Laws, 93 Harv. L. Rev. 322 (1970).  

Whatever the outer limits of the Rule, petitioner Chiarella's case fits neatly near the center of its analytical framework. He occupied a relationship to the takeover companies giving him intimate access to concededly material information that was sedulously guarded from public access. The information, in the words of Cady, Roberts & Co., 40 S. E. C., at 912, was "intended to be available only for a corporate purpose and not for the personal benefit of anyone." Petitioner, moreover, knew that the information was unavailable to those with whom he dealt. And he took full, virtually riskless advantage of this artificial information gap by selling the stocks shortly after each takeover bid was announced. By any reasonable definition, his trading was "inherent[y] unfair[]." *Ibid.* This misuse of confidential information was clearly placed before the jury. Petitioner's conviction, therefore, should be upheld and I dissent from the Court's upsetting that conviction.

STANLEY S. ARKIN, New York, N.Y. (MARK S. ARISOHN, ARKIN & ARISOHN, and ARTHUR T. CAMBOURIS, with him on the brief) for petitioner; STEPHEN M. SHAPIRO, Assistant to the Solicitor General (WADE H. McCREE, JR., Solicitor General, PHILIP B. HEYMANN, Assistant Attorney General, KENNETH S. GELLER, Deputy Solicitor General, SARA CRISCITELLI, and JOHN S. SIFFERT, Justice Department attorneys; RALPH C. FERRARA, General Counsel; PAUL GONSON, Principal Associate General Counsel, JAMES H. SCHROPP, Assistant General Counsel, and MYRNA SIEGEL, SEC attorney, with him on the brief) for respondent.

---

No. 78-1893

United States, Petitioner. 
On Writ of Certiorari to the 
Glen M. Clarke et al. 
United States Court of Appeals 
for the Ninth Circuit. 

[March 18, 1980]

**SYLLABUS**

**Held**: Title 25 U. S. C. § 357, which provides that lands allotted in sevency to Indians may be "condemned" for any public purpose under the laws of the State or territory where located, does not authorize a state or local government to "condemn" allotted Indian trust lands by physical occupation. Under the "plain meaning" canon of statutory construction, the term "condemned" in §357 refers to a formal condemnation proceeding brought by the condemning authority for the purpose of acquiring title to private property and paying just compensation for it, not to an "inverse condemnation" action by a landowner to recover compensation for a taking by physical intrusion. Thus, the Court of Appeals erred in holding that §357 permitted acquisition of allotted lands by inverse condemnation by certain cities in Alaska, even though Alaska law might allow the exercise of the power of eminent domain through inverse condemnation.

500 F. 2d 766, reversed.

REHNQUIST, J., delivered the opinion of the Court, in which BRENNAN, C. J., and BRENNER, STEWART, MARSHALL, POWELL, and STEVENS, JJ., joined. BLACKMUN J., filed a dissenting opinion, in which WHITE, J., joined.

Mr. Justice REHNQUIST delivered the opinion of the Court.

We granted the petition for certiorari of the United States in this case to decide the question "whether 25 U. S. C. § 357 authorizes a state or local government to ‘condemn’ allotted Indian trust lands by physical occupation?" Pet. 2. That statute, in turn, provides in pertinent part:

["L]ands allotted in sevency to Indians may be condemned for any public purpose under the laws of the State or Territory where located in the same manner as land owned in fee may be condemned, and the money awarded as damages shall be paid to the allottee.

We think this is a case in which the meaning of a statute may be determined by the admittedly old-fashioned but nonetheless still entirely appropriate "plain meaning" canon of statutory construction. We further believe that the word "condemned," at least as it was commonly used in 1901, when 25 U. S. C. § 357 was enacted, had reference to a judicial proceeding instituted for the purpose of acquiring title to private property and paying just compensation for it.

Both the factual and legal background of the case are complicated, but these complications lose their significance under our interpretation of § 357. For it is conceded that neither the city of Glen Alps nor the city of Anchorage, both Alaska municipal corporations, ever brought an action to condemn the lands here in question in federal court as required by Minnesota v. United States, 305 U. S. 382 (1939). And since we hold that only in such a formal judicial proceeding may lands such as this be acquired, the complex factual and legal history of the dispute between the government, respondent Glen M. Clarke et al., and respondent Bertha Mae Tabbytite need not be recited in detail.

The Court of Appeals for the Ninth Circuit held that § 357 permits acquisition of allotted lands by what has come to be known as "inverse condemnation." In so holding, the court reasoned that "once the taking has been accomplished by the state it serves little purpose to interpret the statute to refuse to permit an inverse condemnation suit to be maintained on the ground that the state should have filed an eminent domain suit."

...
Marilyn Friedman, Esq.
Municipal Assistance Corporation
Two World Trade Center
Room 4540
New York, New York

Dear Marilyn:

In case you did not see it, I enclose a copy of the decision of the Appellate Division, First Department, in Washburn v. Goldin, together with an explanatory memo I wrote to Judge Rifkind on the subject.

Also, on the Flushing National Bank moratorium case, I spoke to Jim Greilsheimer yesterday. As you may know, at the urging of the underwriters, the City is attempting to make provision to pay off all of the moratorium notes held by the public before their new note issue in November, rather than by the February 28, 1978 cut-off date we previously discussed. Therefore, Jim is revising the form of order you and I previously received. He expects to send us both a copy of the new order probably early next week. He says it will adopt the language you and I discussed to make sure that notes held by MAC are not covered. We can discuss the order when it is received.

Best regards.

Sincerely,

Robert L. Laufer

Enclosures
OFFICE MEMORANDUM

To: Judge Rifkind
From: Bob Laufer
CC: Allen Thomas

Date: October 27, 1977
Memo of Fact [X]  Memo of Law [   ]

Subject: Washburn v. Goldin

I attach a copy of a decision by the Appellate Division, First Department, which appeared in the Law Journal this morning, affirming the dismissal of the petition in the above action. MAC was not named as a party in this action, but we worked with the City on it. The critical issue which was raised in the proceeding was whether the City could allow short-term notes, in the hands of the banks, MAC or anyone else, to remain outstanding beyond their initial due date.

I do not know whether plaintiff intends to take the case higher.

R.L.L.
MATTER OF WASHBURN, JR.,
pet.-ap. (Goldin, rea-reas) - Judgment, Supreme Court, New York County (Helman, V.), entered on Feb. 2, 1977, dismissing the cross-motion of the City of New York to dismiss the petition, unani-
mosly affirmed. Respondent shall recover of appellee 50% costs and dis-
bursements of this appeal.

This proceeding was brought by the petitioner to challenge the extension agreement among the holders of Revenue Anticipation Notes, Tax Anticipation Notes, and the City of New York. The petitioner's position is that these notes cannot be extended beyond the dates on which the taxes or revenues anticipated have been actually received by the city.

Petitioner's standing to bring this proceeding is predicated on a claim that they are taxpayers within the meaning of General Municipal Law, Sec. 51, in that they own a proprietary lease in a cooperative corporation. However, persons qualified to sue within the intenden-
t of General Municipal Law, Sec. 51, must hold stock or property assessed at $1,000 or more. An interest in a cooperative corporation, as claimed by the petitioner, is an interest in personality and not realty (Silverman v. Alee Plaza Associates, 35 A.D. 2d 166), and petitioners therefore have no standing to bring this suit. The petition was properly dismissed (Food Mart Assocs. v. City of New York, 44 Misc. 2d 374, aff'd 36 A.D. 2d 693).

We further note that petitioner's counsel should in any event be disqualified. Upon motion of the City of New York, the petitioners' attorney was found disqualified to serve as counsel for proposed intervenors in an action against the Municipal Assistance Corporation due to his prior association with that corporation, and the City having given him "ac-

cess to files and confidential material" (Flushing National Bank v. Municipal Assistance Corporation, N.Y., L.J., June 30, 1974, p. 15, col. 3). Because this proceeding has its genesis in an agreement between the Municipal Assistance Corporation and the stockholders, petitioner's counsel should be disqualified for the same reason.

In view of our dismissal on procedural grounds, we do not reach the merits.

All concur, except Kupferman, J.P., who concurs in the result in the following memorandum:

While I concur in the result, I must specifically take issue with the holding that petitioners have no standing to bring this suit. It is simplistic to find that because one owns a cooperative apart-

ment rather than real property, one has no standing.

The exact nature of the interest is still not well defined. See Note, Legal Characterization of the Individual's Interest in a Cooperative Apartment: Realty or Personality?, 73 Columbia L. Rev. 250 (1973). The Court of Appeals has indicated that there is a "constantly changing view in this State of standing to sue in order to challenge the legality of official action ..." (Matter of Robert Abrams v. New York City Transit Authority, 39 N.Y. 2d 950, 291; see also Little Joseph v. Babylon, 41 N.Y. 2d 728; Black Brook v. Stat., 41 N.Y. 2d 480; Wein v. Carey, 41 N.Y. 2d 491).

The real issue is whether the conten-

tion raised is frivolous or whether the plaintiff has a legitimate stake in the body politic. The owner of a cooperative apart-

ment on Park Avenue in the "Silk Stocking" area certainly has an interest in real estate far in excess of the minimum requirement within the mean-

ing of the General Municipal Law Sec. 51.

Order filed.
When Bob Steves and Ted Holmes, each of the State Comptroller's Office, were here yesterday, we discussed the shorthand designations of the various Wein cases in order to come up with a common understanding of which case is which.

I offer the following list as a semi-official list of those cases so that we may all use a common set of designations:

**Wein I - SRC:** The original case attacking the constitutionality of the Stabilization Reserve Corporation.

**Wein II - MAC Notes:** The case attacking the $250 million advance from the State to MAC under the gift or loan of credit clauses of the State Constitution.
Wein III - State Insurance Fund Indemnification: The attack on the legislation providing indemnification with respect to certain state insurance fund purchases of securities.

Wein IV - Deficit Notes: The current Wein attack, using the Wein II decision, on the 1976 State Spring Note sale and on all state note sales before the state budget its balance.

Wein V - Commodore Tax Abatement: I do not know anything more about this case.

Wein VI - Back Bonding: Again, I do not know anything more about this case.

Wein VII - Son of Flushing I: The current Wein attack on the "diversion" of sales tax and stock transfer tax from the City to MAC.
MAC vs. Moody's Investors Service
(proposed litigation)
1977-1981
SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

MUNICIPAL ASSISTANCE CORPORATION
FOR THE CITY OF NEW YORK,

Plaintiff,

against

MOODY'S INVESTORS SERVICE, INC.,

Defendant.

Plaintiff Municipal Assistance Corporation For The City of New York ("MAC"), by its attorneys Paul, Weiss, Rifkind, Wharton & Garrison, complaining of defendant, alleges:

1. Plaintiff MAC, a public benefit corporation, is a corporate governmental agency and instrumentality of the State of New York, with principal offices at Two World Trade Center, New York, New York.

2. MAC was created by acts of the New York State Legislature on June 10, 1975 to assist New York City in attempting to provide essential services to its inhabitants while meeting its obligations to the holders of New York City securities.

3. Among other activities, MAC issues and sells notes and bonds to the general public, to banks, to governmental pension funds, and others. In the period June 10, 1975 to date, MAC has issued and sold bonds and notes in an aggregate amount exceeding $3,800,000,000.
4. MAC's credit standing with the financial community and the investing public is of vital importance to its ability to function and to carry out its legislative mandate.

5. On information and belief, defendant Moody's Investors Service, Inc. ("Moody's") is a Delaware corporation, with its principal offices at 99 Church Street, New York, New York. Moody's is one of three national organizations whose ratings of bonds and other securities are widely followed and relied upon by the financial community and the investing public.

6. In June, 1975, Moody's and MAC entered into an agreement (the "Agreement") whereby, for a fee, Moody's undertook to make an examination of the quality and credit-worthiness of an initial issue of MAC bonds (the 1975 Series A Bonds); to assign a rating to such bonds on the basis of such examination; to communicate such rating to MAC and thereafter to publish and disseminate such rating to the investing public; and to monitor and review such rating for a year following the sale of the bonds.

7. Moody's also agreed that during the succeeding year, upon request, an analysis and rating would be made of any subsequent issue of MAC bonds for a fee one-half that charged for rating the initial issue.
8. On or about July 2, 1975, Moody's announced that it had assigned a rating of "A" to MAC's 1975 Series A Bonds, and on August 12, 1975, it announced that it had assigned a rating of "A" to MAC's 1975 Series B Bonds.

9. Pursuant to the Agreement, MAC paid Moody's fees of $4,000 and $2,000, respectively, in connection with its ratings on MAC's 1975 Series A and Series B Bonds.

10. An "A" rating from Moody's is widely regarded by the financial community and investing public as a good rating. According to Moody's literature, bonds so rated "possess many favorable investment attributes and are to be considered as upper medium grade obligations."

FIRST CAUSE OF ACTION

11. By the Agreement, Moody's undertook to review and analyze MAC's bonds, and to monitor those bonds for a year, with due care, accuracy and professional skill. Indeed Moody's warranted that its examination and rating of bonds would be conducted under "the highest possible standards of professional competence for the financial community."

12. On May 26, 1976, Moody's flagrantly breached that key term of the Agreement, as follows:
13. On May 24, 1976, MAC publicly announced an exchange offer whereby holders of New York City short-term notes could exchange their notes for certain MAC bonds (the "Exchange Offer").

14. In a separate transaction, on May 25, 1976, MAC published an advertisement in major newspapers soliciting from the holders of Bonds issued under MAC's General Bond Resolution adopted July 2, 1975 certain consents (the "Notice"). The Notice clearly and conspicuously advised holders of such bonds to obtain and read an additional document called "Additional Information as to the Effects of the Adjustment Described in the Notice" issued by MAC and made widely available, which contains additional information concerning the consents being solicited and certain other information relevant thereto (the "Additional Information").

15. Briefly, the Notice solicited consents to proposed amendments of Sections 203 and 902 of MAC's General Bond Resolution pursuant to which the 1975 Series A and Series B Bonds were issued. The purpose of the amendments was to enable MAC to implement, and to facilitate the implementation of, the Amended and Restated Agreement of November 26, 1975 among MAC, certain banks, pension and sinking funds, for the restructuring of maturities and interest rates of MAC bonds held by those banks and funds.
16. In violation of the most elementary standards of professional care and competence, Moody's inexplicably omitted to obtain a copy of the Additional Information. Instead, Moody's completely misread the Notice and, relying upon that misreading alone, on May 26, 1975, Moody's precipitously downgraded its prior rating of MAC bonds from "A" to "B" -- a drop of three investment grades. Obligations rated "B," according to Moody's, "generally lack characteristics of the desirable investment."

17. Such a precipitous downgrading of a governmental agency's security is virtually unheard of in the financial community.

18. Moreover, in utter disregard of the customary practice in the profession, and despite Moody's own prior statements to MAC concerning the "complexity and amount of work" involved in analyzing MAC's bonds, Moody's failed even to attempt to speak to MAC concerning the facts of the Notice and Additional Information before taking the extraordinary and hasty step of precipitously downgrading MAC's bonds.

19. Furthermore, the report which Moody's issued in connection with its rating change makes it clear that the downgrading -- which was not concurred in by the other major
rating services, Standard & Poor's and Fitch -- was based entirely on a misreading of the Notice and Moody's failure to follow the most basic standards of its profession. Thus, Moody's report contains numerous errors, among which are the following:

(a) **Moody's said** that MAC was now "proposing" a restructuring of its bonds held by banks, pension and sinking funds, and that such restructuring "raise[s] serious questions as to the security of" MAC's bonds.

In fact, as Moody's knew, the restructuring was agreed to by MAC, the banks, sinking and pension funds, and announced, six months ago, as part of the aforesaid Amended and Restated Agreement of November 26, 1975 -- about which Moody's knew and never before expressed any concern -- and, in fact, the restructuring has no detrimental effect whatsoever on the security of MAC's bonds.

(b) **Moody's said** that "without [the restructuring and the amendments for which consents were solicited] MAC would not have sufficient revenues to meet its coverage requirements and comply with debt limits, and would not be able to carry out its agreement with New York City."

In fact, the restructuring and proposed amendments have no material effect on MAC's ability to meet its coverage requirement and comply with its debt limit.
Moody's knew or should have known from publicly available information -- and had Moody's obtained a copy of the Additional Information, it would have seen clearly -- that MAC's coverage requirements are ample with or without the restructuring and proposed amendments.

In fact, there is no "agreement with New York City" as stated by Moody's.

(c) **Moody's said**, quoting entirely out of context from the Notice, that "Without such amendments [MAC] could not carry out certain terms of the [Amended and Restated Agreement of November 26, 1975] without being in default under the [General Bond Resolution]."

In fact, as the Notice makes clear, (i) consent of only two-thirds of the holders of bonds issued under the General Bond Resolution is required, (ii) the banks, pension and sinking funds that are signatories to the November 26 agreement, and the State of New York, together hold two-thirds of such bonds, and (iii) MAC has no reason to expect that all of those holders would not give the requested consents. Thus, Moody's statement is at the very least misleading in its omission of these critical facts.

(d) **Moody's said** that the revocation period for the solicited consents is 120 days, and that this creates a long period of uncertainty for holders of New York City notes who are considering the Exchange Offer.
In fact, as clearly stated in the Notice, the consents may be revoked only up to the time when the Trustee of the MAC bonds gives notice to MAC that the requisite percentage of consents has been received. Since, as stated in the Notice, MAC has requested that consents be given by June 10, 1976, and expects that the Trustee will receive the requisite percentage of consents by that date, there is no long period of uncertainty.

(e) Moody's said that "there have been suggestions by governmental officials in the City and MAC that bankruptcy is a desirable alternative and for the City."

In fact, no such suggestion has been made by any MAC official.

(f) Moody's said that the prospect of bankruptcy action by the City "would certainly involve the MAC financing."

In fact, MAC is not dependent upon the New York City government or budget for its revenues. Rather, its revenues are derived entirely from State sources, principally State sales and use taxes which are appropriated by the State, not the City. The New York Supreme Court has upheld the constitutionality of the legislation imposing such State sales and use taxes within the City, and has directed the State Tax Commissioner to collect the sales and use taxes and remit the proceeds to MAC as required by such legislation. Thus, City bankruptcy would not deprive MAC of the revenue sources which are the security for its bonds.
20. In sum, Moody's downgrading of MAC's bonds was the result of its egregious misreading of the Notice; its failure to obtain and read the Additional Information; its failure to seek or obtain any information from MAC or appropriate legal advice; and its failure to follow elemental standards of prudence, competence and professionalism.

21. In consequence, Moody's downgrading of MAC's bonds constitutes a material breach of the warranties in the Agreement, including the warranty that Moody's would act under "the highest possible standards of professional competence for the financial community."

22. By reason of Moody's breach of contract, MAC has been injured in at least the following respects:

(a) MAC's credit standing has been impaired, and the market prices of its bonds plummeted upon release of Moody's change in rating;

(b) the success of the Exchange Offer has been jeopardized due to New York City noteholders' concern over the safety and credit-worthiness of MAC bonds which was engendered by Moody's change in rating; and
(c) MAC had proposed to issue and sell a series of "mini" bonds in July, 1976 and, as a consequence of Moody's actions, the interest rate required to be paid by MAC on such bonds may be substantially higher than previously anticipated.

23. MAC is entitled to recover at least the following amounts by way of damages:

(a) $6,000 paid to Moody's pursuant to the Agreement;

(b) a sum exceeding $ representing printing, legal, advertising and other costs incurred by MAC in connection with the Exchange Offer which may now have been frustrated by Moody's action;

(c) a sum which cannot presently be determined representing increased interests costs for the proposed "mini" bonds; and

(d) a sum which cannot presently be determined but which is estimated to exceed $ million, representing the damage to MAC's credit standing.

SECOND CAUSE OF ACTION

24. Plaintiff repeats and realleges paragraphs 1-23 hereof.
25. At all relevant times, Moody's held itself out to MAC and the public as a financial reporting and rating service possessing the requisite professional skill, knowledge and experience to review, analyze and rate, with care and accuracy, the bonds of governmental agencies, and to prepare complete and accurate reports thereon, in accordance with generally accepted standards and practices in the profession.

26. In its downgrading of MAC's bonds, Moody's acted recklessly, unprofessionally, and in gross violation of the standards of care customarily practiced by financial reporting and rating services and prevalent in the financial community.

27. As a consequence of Moody's tortious conduct, MAC has been damaged in at least the respects set forth in paragraph 22 hereof, and it is entitled to recover damages as set forth in paragraph 23 hereof.

WHEREFORE, MAC demands judgment against Moody's in an amount which cannot presently be determined but which
exceeds $ , together with the costs and disbursements of this action.

Dated: June , 1976.

PAUL, WEISS, RIFKIND, WHARTON, & GARRISON
Attorneys for Plaintiff
345 Park Avenue
New York, N.Y. 10022
644-8000
June 7, 1976

Mr. Felix G. Rohatyn
Lazard Freres & Co.
One Rockefeller Plaza
New York, New York 10020

MAC/Moody's

Dear Felix:

Enclosed you will find the following documents:

(1) Summons and Complaint in proposed action against Moody's.

(2) Notice of Motion, Affidavit (with exhibits) and Memorandum of Law in support of motion seeking disclosure from Moody's before service of a complaint.

I await your comments and instructions.

Sincerely,

Simon H. Rifkind

Enclosures

BY HAND

P.S. 1st & 2nd attachments are incorrect. Proceed as per enclosed.
Index No.

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

MUNICIPAL ASSISTANCE CORPORATION FOR THE CITY OF NEW YORK,

Plaintiff,

—against—

MOODY'S INVESTORS SERVICE, INC.,

Defendant.

NOTICE OF MOTION AND SUPPORTING AFFIDAVIT

Paul, Weiss, Rifkind, Wharton & Garrison

Attorneys for Plaintiff

345 PARK AVENUE, NEW YORK, N.Y. 10022
644-8000

All communications should be referred to Robert L. Laufer, Esq.
SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

MUNICIPAL ASSISTANCE CORPORATION
FOR THE CITY OF NEW YORK

Plaintiff,

-against-

MOODY'S INVESTORS SERVICE, INC.,

Defendant.

NOTICE OF MOTION

S I R S:

PLEASE TAKE NOTICE that, upon the annexed affidavit of Simon H. Rifkind, sworn to June 1976 ("Rifkind Affidavit"), and upon the Summons with Notice herein, the undersigned will move this Court at a Special Term, Part I thereof, to be held at the County Court House, 60 Centre Street, New York, New York, on June 1976, at 9:30 A.M., or as soon thereafter as counsel can be heard, for an order, pursuant to Section 3102(c) and Rules 3107 and 3120(a) of the CPLR, as follows:

1. Permitting plaintiff (a) to take the deposition of defendant pursuant to the Notice of Deposition annexed as Exhibit B to the Rifkind Affidavit, and (b) to obtain discovery and production of documents from defendant pursuant to the Notice for Discovery and Inspection annexed as Exhibit C to
the Rifkind Affidavit, in order to aid plaintiff in bringing this action.

2. Extending the time of plaintiff to serve its complaint in this action until a date ten (10) days after the conclusion of its deposition of defendant.

3. For such other and further relief as to this Court may seem just and proper.

Dated: New York, New York
June , 1976

Yours, etc.

PAUL, WEISS, RIFKIND, WHARTON & GARRISON
Attorneys for Plaintiff
345 Park Avenue
New York, New York 10022
(212) 644-8000

TO:

MOODY'S INVESTORS SERVICE, INC.
99 Church Street
New York, New York 10007
SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

MUNICIPAL ASSISTANCE CORPORATION FOR THE CITY OF NEW YORK,

Plaintiff,

against

MOODY'S INVESTORS SERVICE, INC.,

Defendant.

STATE OF NEW YORK )
COUNTY OF NEW YORK )

SIMON H. RIFKIND, being sworn, states:

1. I am a member of the firm of Paul, Weiss, Rifkind, Wharton & Garrison, attorneys for plaintiff Municipal Assistance Corporation For The City of New York ("MAC"). I submit this affidavit in support of MAC's motion, pursuant to CPLR 3102(c), for an order permitting MAC to obtain disclosure from defendant Moody's Investors Service, Inc. ("Moody's") to aid MAC in framing its complaint.

2. As I shall describe below, MAC has been gravely injured by Moody's recent, precipitous downgrading of its rating of MAC bonds, and MAC has substantial causes of action against Moody's, as a result of that downgrading, for breach of contract and for careless and unprofessional conduct on the part of
Moody's. Consequently, MAC commenced this action by service of a summons on June , 1976.* Immediate disclosure under CPLR 3102(c) is needed, however, (a) to enable MAC properly and carefully to frame its allegations on those causes of action and (b) to enable MAC to determine whether its complaint should plead additional causes of action.

The Background

3. MAC is a public benefit corporation, created as a corporate governmental agency and instrumentality of the State of New York by acts of the New York State Legislature on June 10, 1975. Its offices are at 2 World Trade Center, New York, New York. As the Court is no doubt aware, MAC was created by the Legislature to assist New York City in its efforts to provide essential services to its inhabitants while meeting its obligations to the holders of New York City securities.

4. The principal means by which MAC carries out its legislatively-mandated functions is the issuance and sale of its notes and bonds to the general public, to banks, to govern-

* A copy of the summons is annexed hereto as Exhibit A. Exhibits B and C annexed hereto are copies of the Notice of Deposition and Notice for Discovery and Inspection which MAC now seeks permission to serve on Moody's.
ment pension funds, and to others. Since its creation, MAC has issued and sold bonds and notes in an aggregate amount exceeding $3,800,000,000.

5. Thus, MAC's credit standing with the financial community and the investing public is of vital importance to its ability to function and carry out its mandate.

6. Defendant Moody's, a Delaware corporation with principal offices at 99 Church Street, New York, New York, is one of three national organizations whose ratings of bonds and other securities are widely followed and relied upon by the financial community and the investing public.

7. In June, 1975, shortly before MAC issued its first series of bonds (the 1975 Series A Bonds), Moody's and MAC entered into an agreement whereby, for a fee, Moody's undertook to examine the quality and credit-worthiness of such bonds; to assign a rating to those bonds; to communicate that rating to MAC and disseminate it to the investing public; and to monitor and review that rating for a year following the sale of the bonds (the "Agreement"). Moody's also agreed that during the succeeding year, upon request, an analysis and rating would be made on any subsequent issue of MAC bonds for a fee one-half that charged for rating the initial issue.
8. Under the Agreement, Moody's undertook to analyze MAC's bonds, and to monitor them for a year, with due care, accuracy, and professional skill. Indeed, Moody's warranted that its examination and rating of the bonds would be conducted under "the highest possible standards of professional competence for the financial community." Moreover, apart from the Agreement, Moody's has always held itself out to be an organization possessing the requisite professional skill, knowledge and experience to review and rate, with care and accuracy, the bonds of governmental agencies.

9. On or about July 2, 1975, Moody's announced that it had assigned a rating of "A" to MAC's 1975 Series A Bonds, and on August 12, 1975 it announced that it had assigned the same rating of to MAC's Series B Bonds. Pursuant to the Agreement, MAC paid Moody's fees of $4,000 and $2,000, respectively, in connection with these ratings.

10. An "A" rating from Moody's is widely regarded by the financial community and the investing public as a good rating. Moody's literature states that bonds so rated "possess many favorable investing attributes and are to be considered as upper medium grade obligations."
The Facts Giving Rise to This Lawsuit

11. On May 24, 1976, MAC publicly announced an exchange offer whereby holders of New York City short-term notes could exchange those notes for certain MAC bonds (the "Exchange Offer").

12. In a separate transaction, on May 25, 1976, MAC published an advertisement in major newspapers soliciting from the holders of its bonds issued under the General Bond Resolution adopted July 2, 1975 certain consents (the "Notice"). The Notice clearly and conspicuously advised holders of such bonds to obtain and read an additional document called "Additional Information as to the Effects of the Adjustment Described in the Notice," issued by MAC and made widely available, which contains additional information concerning the consents being solicited and certain other information relevant thereto (the "Additional Information").

13. Briefly, the Notice solicited consents to proposed amendments of Sections 203 and 902 of MAC's General Bond Resolution pursuant to which the 1975 Series A and Series B Bonds were issued. The purpose of the amendments is to enable MAC to implement, and to facilitate the implementation of, an Amended and Restated Agreement of November 26, 1975 among MAC, certain banks, and pension and sinking funds, for the restruc-
turing of maturities and interest rates of MAC bonds held by those banks and funds.

14. But, only a day after the publication of the Notice, on May 26, 1976, Moody's suddenly, without any prior warning, precipitously announced that it had downgraded its prior rating of MAC bonds from "A" to "B" -- a drop of three investment grades. Obligations rated "B", according to Moody's Literature, "generally lack characteristics of the desirable investment."

15. The effect of the downgrading on MAC was immediate, dramatic, and severe. Market prices of outstanding MAC bonds plummeted upon news of Moody's change in rating. In addition, MAC's Exchange Offer has been seriously jeopardized by the concern which Moody's has engendered in New York City noteholders over the safety and credit-worthiness of MAC bonds. As a consequence, MAC has lost $ by way of printing, legal, and advertising fees expended in connection with that Exchange Offer. Also, MAC's future issue of "mini-bonds," scheduled for issuance in July, now may have to bear a higher rate of interest because of Moody's action. And the damage to MAC's credit standing in general can only be measured in the tens of millions -- if not the hundreds of millions -- of dollars.
16. In short, it is clear that MAC has been severely injured by Moody's action.

17. It is clear, as well, that Moody's action was not innocent. Rather, it was the result of serious breaches of professional conduct by Moody's. For Moody's announcement of the change in rating was accompanied by a report (the "Report") which purported to state Moody's reasons for changing the rating on MAC's bonds, and the Report is filled with egregious errors of fact -- errors that can only be the result of gross violations of the standards of accuracy and care to be expected of a financial rating service. Among the errors in the Report (a copy of which is annexed hereto as Exhibit D) are the following:

(a) Moody's said that MAC was now "proposing" a restructuring of its bonds held by banks, pension and sinking funds, and that such restructuring "raise[s] serious questions as to the security of" MAC's bonds.

In fact, the restructuring was agreed to by MAC, the banks, and the pension and sinking funds, and announced, six months ago, as part of the aforesaid Amended and Restated Agreement of November 26, 1975; and, in fact, the restructuring has no detrimental effect whatsoever on the security of MAC's bonds.

(b) Moody's said that "without [the restructuring and the amendments for which consents were solicited] MAC would not have sufficient revenues to meet its coverage
requirements and comply with debt limits, and would not be able to carry out its agreement with New York City."

In fact, the restructuring and proposed amendments have no material effect on MAC's ability to meet its coverage requirement and comply with its debt limit: MAC's coverage requirements are ample with or without the restructuring and proposed amendments. Furthermore, there is no such "agreement with New York City."

(c) Moody's said, quoting entirely out of context from the Notice, that "Without such amendments, [MAC] could not carry out certain terms of the [Amended and Restated Agreement of November 26, 1975] without being in default under the [General Bond Resolution]."

In fact, as the Notice makes clear, (i) consent of only two-thirds of the holders of bonds issued under the General Bond Resolution is required, (ii) the banks, pension and sinking funds that are signatories to the November 26 agreement, and the State of New York, together hold two-thirds of such bonds, and (iii) MAC has no reason to expect that all of those holders would not give the requested consents. Thus, Moody's statement is at the very least misleading in its omission of these critical facts.

(d) Moody's said that the revocation period for the solicited consents is 120 days, and that this creates a long period of uncertainty for holders of New York City notes who are considering the Exchange Offer.

In fact, as clearly stated in the Notice, the consents may be revoked only up to the time when the Trustee of the MAC bonds gives notice to MAC that the requisite percentage of consents has been received. Since, as stated in the Notice, MAC has requested that consents be given by June 10, 1976, and expects that the Trustee will receive the requisite percentage of consents by that date, there is no long period of uncertainty.
(e) Moody's said that "there have been suggestions by governmental officials in the City and MAC that bankruptcy is a desirable alternative for the City."

In fact, no such suggestion has been made by any MAC official.

(f) Moody's said that the prospect of bankruptcy action by the City "would certainly involve the MAC financing."

In fact, MAC is not dependent upon the New York City government or budget for its revenues. Rather, its revenues are derived entirely from State sources, principally State sales and use taxes which are appropriated to MAC by the State Legislature, not the City. The New York Supreme Court has upheld the constitutionality of the legislation imposing such State sales and use taxes within the City, and has directed the State Tax Commissioner to collect the sales and use taxes and remit the proceeds to MAC as required by such legislation. Thus, City bankruptcy would not deprive MAC of the revenue sources which are the security for its bonds.

18. The errors in Moody's Report, which was the basis of the change in rating, are so numerous and flagrant that, in and of itself the Report establishes prima facie causes of action against Moody's for breach of its contract warranty to exercise due care in reviewing MAC's bonds, and for professional malpractice. And, significantly, the other major rating services -- Standard & Poor's and Pitch -- have reviewed all the facts and determined not to downgrade MAC's bonds.
19. Thus, I submit it is clear that MAC has at least two causes of action, as I have indicated, against Moody's.

The Need for Immediate Disclosure

20. Nevertheless, MAC needs the disclosure requested by this motion properly to frame its allegations against Moody's: although it is evident that there has been wrongdoing on the part of Moody's, disclosure is needed to ascertain the genesis of the errors in Moody's Report and the nature and extent of its wrongdoing.

21. For example, we believe that, although the Notice advised the reader to obtain and read a copy of the Additional Information, Moody's inexplicably failed to obtain and read the Additional Information. We believe that, instead, Moody's employees misread the Notice and committed the errors set out in Moody's Report by relying on that misreading alone. We seek disclosure to determine (a) whether Moody's saw or read the Additional Information and (b) the ages, training, and experience of the Moody's employees who read the Notice and/or Additional Information and who wrote the Report.

22. We believe that a drop of three investment grades in the rating of a government agency's security is virtually
unheard of in the financial community. We seek to determine whether Moody's has ever before so precipitously changed a rating.

23. We believe that it is customary for a rating service to communicate with, and seek information from, an issuer before making a drastic rating change and that, in this case, Moody's made no attempt to communicate with or obtain information from MAC. We seek to determine whether we are correct.

24. We believe that Moody's failed to seek or obtain legal advice concerning what it previously had stated to be the "complex" matters relating to MAC's bonds. We seek to determine whether we are correct.

25. Moody's Report stated that MAC's "propos[ed]" restructuring of its bonds held by banks, pension and sinking funds "raised serious questions as to the security of" MAC bonds. But we believe that Moody's has known of the November 26, 1975 agreement pursuant to which such restructuring is to take place for months, and that Moody's never before had raised any question or objection to such agreement. We seek to determine whether we are correct.

26. We believe Moody's had before it publicly available data which demonstrate the falsity of the statement in
Moody's Report that "without [the restructuring and the amendments for which consents were solicited] MAC would not have sufficient revenues to meet its coverage requirements and comply with debt limits ...." We seek to determine whether we are correct.

27. We believe that there is absolutely no basis for Moody's statement that "there have been suggestions by government officials in ... MAC that bankruptcy is a desirable alternative for the City." We seek to determine whether we are correct.

28. In sum, we believe that Moody's downgrading of MAC's bonds resulted from its failure to follow elementary standards of care, competence and professionalism. Accordingly, MAC has causes of action against Moody's (a) for breach of Moody's warranty that it would act under the "highest possible standards of professional competence for the financial community" and (b) for Moody's tortious failure to act in accordance with the generally accepted standards of its profession. The requested disclosure is needed to ascertain the precise facts upon which these causes of action should be pleaded.

29. In addition, the requested disclosure would enable MAC to determine whether it has, and should plead,
additional causes of action against Moody's. For example, if Moody's actions were more than merely negligent or carelessness -- if, for example, Moody's acted recklessly -- MAC may have a cause of action for injurious falsehood. Or, if Moody's acted with intent to injure MAC, it could state a cause of action for prima facie tort.

30. Thus the requested disclosure would enable MAC to ascertain what form any additional causes of action to be pleaded against Moody's should take.

31. As shown in the accompanying memorandum of law, these are precisely the reasons that traditionally justify the granting of a motion under CPLR 3102(c) for disclosure to aid in the framing of a complaint.

32. In this case, moreover, there are special additional considerations which justify the grant of such disclosure. Moody's is a well-known and widely recognized rating service. The allegations against Moody's described above are serious indeed. No litigant -- and certainly no public agency such as MAC -- wishes to make charges against a defendant such as Moody's loosely. The allegations in MAC's proposed complaint ought to be stated as specifically, concisely, and as accurately
as the facts permit. It is to obtain those facts, and thus carefully to frame its allegations against Moody's, that MAC seeks the disclosure requested by this motion.

33. I respectfully urge that MAC's motion for disclosure pursuant to CPLR 3102(c) be granted in all respects.

_____________________________
Simon H. Rifkind

Sworn to before me this day of June, 1976.

_____________________________
Notary Public
Supreme Court of the State of New York
County of NEW YORK

MUNICIPAL ASSISTANCE CORPORATION FOR THE CITY
OF NEW YORK,

against

MOODY'S INVESTORS SERVICE, INC.,

Plaintiff(s) designates
New York
County as the place of trial
The basis of the venue is
Defendant's residence

Summons with Notice
Plaintiff(s) reside(s) at
Two World Trade Center
County of New York

To the above named Defendant(s):

You are hereby summoned to answer the complaint in this action and to serve a copy of your answer, or, if the complaint is not served with this summons, to serve a notice of appearance, on the Plaintiff's Attorney(s) within 20 days after the service of this summons, exclusive of the day of service (or within 30 days after the service is complete if this summons is not personally delivered to you within the State of New York); and in case of your failure to appear or answer, judgment will be taken against you by default for the relief demanded herein.

Dated, June 1, 1976

Defendant's Address:
99 Church Street
New York, N.Y. 10007
Notice: The object of this action is
Relief due to breach of contract
and professional malpractice.
The relief sought is damages.

PAUL, WEISS, RIFKIND, WHARTON & GARRISON
Attorney(s) for Plaintiff(s)
Office and Post Office Address
345 Park Avenue
New York, New York 10022
(212) 644-8000

EXHIBIT A
SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

MUNICIPAL ASSISTANCE CORPORATION FOR THE
CITY OF NEW YORK,

Plaintiff,

-against-

MOODY'S INVESTORS SERVICE, INC.,

Defendant.

S I R S:

PLEASE TAKE NOTICE that, pursuant to Article 31 of
the Civil Practice Law and Rules, the undersigned will take
the deposition of defendant, by such of its officers, directors,
agents or employees as have knowledge of the facts pertaining
to defendant's issuance of ratings on obligations of plaintiff,
commencing at 10:00 A.M. on the next business day following by
seven (7) days the entry of an order of the above Court per-
mitting said deposition. The deposition will take place at
the offices of the undersigned, before a Notary Public, or
some other officer authorized by law to administer oaths, and
will continue on adjourned dates until concluded. You are
invited to attend and cross-examine.

PLEASE TAKE FURTHER NOTICE that pursuant to CPLR 3111,
all said persons to be deposed are required to produce at their
depositions all documents listed on the annexed Schedule in their or defendant's possession, custody or control.

Dated: New York, New York
      June  , 1976

Yours, etc.,

PAUL, WEISS, RIFKIND, WHARTON & GARRISON
Attorneys for Plaintiff
345 Park Avenue
New York, New York 10022
(212) 644-8000

TO:

MOODY'S INVESTORS SERVICE, INC.
99 Church Street
New York, New York 10007
SCHEDULE

All documents* relating to or reflecting the following:

1. Plaintiff or its bonds;
2. Any contracts, agreements or understandings between plaintiff and defendant pertaining to the rating of any bonds of plaintiff during the period June 1, 1975 to June 1, 1976 (the "Period");
3. Any communications, written or oral, between plaintiff and defendant or their respective representatives during the Period;
4. The procedures or standards utilized by defendant in rating municipal obligations during the Period;
5. The rating, including changes in rating, of bonds of plaintiff by defendant during the Period; and
6. The personnel records of all persons involved in the rating or change of rating of bonds of plaintiff by defendant during the Period.

* The term "documents" includes, without limitation, books, records, contracts, surveys, bulletins, publications, drafts, reports, studies, correspondence, memoranda, notes, and other papers.
SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

MUNICIPAL ASSISTANCE CORPORATION FOR THE CITY OF NEW YORK,

Plaintiff,

against-

MOODY'S INVESTORS SERVICE, INC.,

Defendant.

Index No.

NOTICE OF DISCOVERY AND INSPECTION

SIRS:

PLEASE TAKE NOTICE that, pursuant to CPLR 3120, defendant is hereby required to produce, and permit plaintiff to inspect and copy, the documents listed on the annexed Schedule.

Such production, inspection and copying shall take place at the offices of the undersigned at 10:00 A.M. on the next business day following by three (3) days the entry of an order of the above Court permitting such production of documents.

Dated: New York, New York
June , 1976

Yours, etc.,

PAUL, WEISS, RIFKIND, WHARTON & GARRISON
Attorneys for Plaintiff
345 Park Avenue
New York, New York 10022
(212) 644-8000

TO:
MOODY'S INVESTORS SERVICE, INC.
99 Church Street
New York, New York 10007

EXHIBIT C
SCHEDULE

All documents* relating to or reflecting the following:

1. Plaintiff or its bonds;
2. Any contracts, agreements or understandings between plaintiff and defendant pertaining to the rating of any bonds of plaintiff during the period June 1, 1975 to June 1, 1976 (the "Period");
3. Any communications, written or oral, between plaintiff and defendant or their respective representatives during the Period;
4. The procedures or standards utilized by defendant in rating municipal obligations during the Period;
5. The rating, including changes in rating, of bonds of plaintiff by defendant during the Period; and
6. The personnel records of all persons involved in the rating or change of rating of bonds of plaintiff by defendant during the Period.

* The term "documents" includes, without limitation, books, records, contracts, surveys, bulletins, publications, drafts, reports, studies, correspondence, memoranda, notes, and other papers.
May 26, 1976

MUNICIPAL ASSISTANCE CORPORATION FOR THE CITY OF NEW YORK

Rating: 1975 First Resolution Series A and Series B Bonds:

B (Revised from A)

When we first assigned the A rating to the Series A and B bonds of the MAC in June of 1975, there was every prospect that the purpose for which the Corporation was created, namely the funding of City short-term debt into long-term debt in order to improve the City's overall debt structure, was reasonable and that the plans of the Corporation to effect this change were workable. However, subsequent developments, which include the current (second) "swap" offer by the MAC for City noteholders, raise too many questions. The rating was held when the first swap offer was made, even though a new fragmentation was introduced into the City's revenue system. Simultaneously with this second offer the Corporation is proposing the scale down of interest and the restructuring of principal payments, by certain New York City commercial banks, certain New York City pension funds, and certain New York City sinking funds, which are holders of the 1975 Series A and B bonds, of the First Resolution bonds. These actions raise serious questions as to the security of the First Resolution Bonds.

The notice of the interest scale-down and restructuring of principal involves two key amendments to the 1975 First Resolution enabling the Corporation (1) to treat the bonds now being issued in exchange for outstanding bonds as refunding bonds as defined by the Resolution and (2) to permit extensions of maturities of the bonds or extensions of the time of payment of interest on the bonds. The Corporation has stated, in its notice to bondholders, that "Without such amendments, the Corporation could not carry out certain terms of the Agreement without being in default under the Resolution." If Section 203 is not amended, the Corporation would not be in compliance with its statutory limitation on the amount of bonds and notes that it may issue because any bonds issued in the exchange procedure would then be included in such calculation. If Section 902 is not amended, the Corporation would not be in compliance with a covenant in the Resolution which provides that it may not extend the maturity of any of its bonds. The Corporation further states that the
amendment for Section 902 can go into effect only if the debt service coverage test of the Resolution is met.

Implicit in this last statement, as it is in the former concerning a default situation, is the fact that without this exchange and scale down, the MAC would not have sufficient revenues to meet its coverage requirements and comply with debt limits, and would not be able to carry out its agreement with New York City. Both of these amendments, to Section 203 and to Section 902, are as yet only proposals; they require written consent of the holders of at least two-thirds of the principal amount of certain outstanding bonds to become effective, and this has not yet been received.

The MAC's ability to continue to borrow is at the heart of the rescue plans for New York City. Its inability to issue additional debt severely hampers this plan, MAC's original purpose, and would result in further impairment of the performance of the plan. If this "refunding" is not agreed to, the MAC's viability as a debt restructing instrument for New York City is greatly diminished.

The amendment of the First Resolution simultaneously with the second note swap offering puts holders of City moratorium notes under a cloud in appraising revenues likely to be available to support their bonds. The proposed amendments to the Resolution have not yet been formally adopted, and cash flows available to swap bonds can be affected. The exchange offer includes a revocation-of-consent clause extending 120 days after the Corporation has filed notice with the bondholders of the exchange. Consents are to be received by the Corporation by June 10, 1976. This puts the holders and potential holders of second lien MAC bonds in a position of uncertainty.

Our analysis of the 3-year financial plan for the City indicates that it is not working. No provision has been made for eventual payment of the notes under moratorium, budget cuts have not sufficed, and deficits have not been reduced or even stabilized. Increasingly, there have been suggestions by governmental officials in both the City and the MAC that bankruptcy is a desirable alternative for the City. For these reasons: the question, raised by the MAC itself, as to whether it can carry out its agreements and the prospect of bankruptcy action by the City (which would certainly involve the MAC financing), we have revised our rating on the 1975 First Resolution Series A and B bonds from A to B.
SUPREME COURT OF THE STATE OF NEW YORK  
COUNTY OF NEW YORK  

MUNICIPAL ASSISTANCE CORPORATION FOR THE  
CITY OF NEW YORK,  

Plaintiff,  

-against-  

MOODY'S INVESTORS SERVICE, INC.,  

Defendant.  

MEMORANDUM IN SUPPORT OF PLAINTIFF'S  
MOTION FOR LEAVE TO OBTAIN DISCLOSURE  
BEFORE SERVING COMPLAINT  

PAUL, WEISS, RIFKIND, WHARTON & GARRISON  
ATTORNEYS AND COUNSELLORS AT LAW  
345 PARK AVENUE, NEW YORK, N.Y. 10022
SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

MUNICIPAL ASSISTANCE CORPORATION FOR THE CITY OF NEW YORK,

Plaintiff,

against-

MOODY'S INVESTORS SERVICE, INC.,

Defendant.

MEMORANDUM IN SUPPORT OF PLAINTIFF'S MOTION FOR LEAVE TO OBTAIN DISCLOSURE BEFORE SERVING COMPLAINT

This memorandum is submitted in support of the motion of plaintiff Municipal Assistance Corporation for the City of New York ("MAC"), pursuant to CPLR 3102(c), 3107 and 3120(a), for permission to conduct a deposition of, and obtain production of documents from, defendant Moody's Investors Service, Inc. ("Moody's"), in order to aid MAC in bringing this action.

Preliminary Statement

The facts underlying this motion are set forth in the accompanying affidavit of Simon H. Rifkind.* That affidavit demonstrates that certain actions by Moody's -- to wit, its precipitous downgrading of its rating of MAC bonds -- has

* Hereinafter referred to as "Rifkind Affidavit".
caused MAC serious and substantial injury. MAC believes that Moody's actions constitute a material breach of the agreement pursuant to which Moody's undertook to rate MAC bonds, as well as a gross violation of the customary standards of care and competence applicable to financial reporting and rating services.

As a result, MAC today commenced this action against Moody's by service of a Summons with Notice.

By its present motion, MAC seeks permission to obtain certain limited disclosure from Moody's before MAC serves its complaint in this action.

Argument

PLAINTIFF'S MOTION SHOULD BE GRANTED

MAC's request that Moody's be directed to submit to a deposition and to produce documents for MAC's inspection before MAC is required to frame its complaint in this action is supported by both statute and case law.

CPLR 3102(c) expressly provides that, upon court order, a plaintiff may obtain disclosure before an action is commenced in order "to aid in bringing an action." The courts of this State have interpreted this provision to permit a plaintiff to conduct depositions and other discovery procedures before serving a complaint for the purposes, among others, (1) of "dis-
covering the precise facts upon which the cause of action is based, in order to frame pleadings", or (2) to make "the determination as to what form the cause of action should take." In re-Pelley, 43 Misc.2d 1082, 1082-83 (Nassau Co. Ct. 1964); see also, 3A Weinstein-Korn-Miller, New York Civil Practice, ¶ 3102.11, at p. 31-169 (1975). In order to avail himself of the right under CPLR 3102(c) to obtain pre-complaint disclosure for either of such purposes, a plaintiff, in his moving papers, must merely "disclose under oath facts which will fairly indicate he has some cause of action against the adverse party." Stewart v. Socony Vacuum Oil Co., 3 App. Div. 2d 582, 583 (3d Dep't 1957); see, also Salmon v. Feinstein, 25 Misc.2d 963, 966 (Sup. Ct. N.Y. Co. 1960).

As reflected in the Rifkind Affidavit, MAC here meets the above standards.

Thus, it is clear that Moody's precipitous downgrading of its rating of MAC bonds has caused grave damage to MAC. Moody's action appears not only to be unprecedented, but to be a violation of its contract with MAC and contrary to the standards of Moody's profession. The facts, therefore, "fairly indicate" that MAC has some cause of action against Moody's -- e.g., for breach of contract or professional malpractice.

As also reflected in the Rifkind Affidavit, MAC knows that Moody's committed serious and substantial error in down-
grading its rating of MAC bonds, and MAC has a belief as to the
causes of that error. However, without the requested disclosure
by Moody's, MAC cannot know the true nature or extent of Moody's
wrongdoing. In other words, while MAC has a cause of action,
it is "uncertain *** as to the precise facts upon which [it]
may base it" (Silverman v. Nachwarter, 10 Misc. 2d 169, 170
(Sup. Ct. Kings Co., 1956)) and, thus, requires disclosure "in
order to draft or frame a complaint with appropriate allegations
as to the liability of defendant." Leonard v. Home Owners Loan
officially reported).

In other words, MAC seeks disclosure at this point
for the proper purpose of "discovering the precise facts upon
which the cause of action is based, in order to frame" its com-
plaint. In re Pelley, supra.

In addition, as pointed out in the Rifkind Affidavit,
without discovery now, MAC cannot know whether Moody's conduct
was the result of such recklessness or improper motives as to
provide MAC with still other causes of action — e.g., injurious
falsehood or prima facie tort. Disclosure is therefore also
necessary at this time for the proper purpose of permitting MAC
to make "the determination as to what form the cause of action
should take." In re Pelley, supra.
In sum, the case at bar presents a classic case for the utilization of the procedure of pre-complaint disclosure pursuant to CPLR 3102(c).

Finally, MAC's particular requests for disclosure are reasonable. It is well-established that a court, pursuant to CPLR 3102(c), may permit plaintiff "the use of any of the disclosure devices of article 31." See Siegal, Practice Commentaries, C3102:7, vol. 78, McKinney's Consolidated Laws, at p. 267. By its Notice of Deposition and Notice for Discovery and Inspection, MAC seeks only information and documents material and necessary for the preparation of its complaint. See Rifkind Affidavit, Exhibits B and C.

Conclusion

In light of the foregoing, plaintiff's motion should be granted.

Dated: New York, New York
June , 1976

Respectfully submitted,

PAUL, WEISS, RIFKIND, WHARTON & GARRISON
Attorneys for Plaintiff
345 Park Avenue
New York, New York 10022
(212)  644-8000
SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

MUNICIPAL ASSISTANCE CORPORATION FOR THE CITY OF NEW YORK,

Plaintiff,

-against-

MOODY'S INVESTORS SERVICE, INC.,

Defendant.

SUMMONS AND COMPLAINT

Paul, Weiss, Rifkind, Wharton & Garrison

Attorneys for Plaintiff

345 PARK AVENUE, NEW YORK, N.Y. 10022
644-8000

All communications should be referred to Robert L. Laufer, Esq.
Supreme Court of the State of New York
County of NEW YORK

MUNICIPAL ASSISTANCE CORPORATION FOR THE CITY OF NEW YORK,

against

MOODY'S INVESTORS SERVICE, INC.,

Plaintiff

Summons

Plaintiff resides at
Two World Trade Center
County of New York

Defendant

Index No.
Plaintiff designates
New York
County as the place of trial
The basis of the venue is
Defendant's residence

To the above named Defendant

You are hereby summoned to answer the complaint in this action and to serve
a copy of your answer, or, if the complaint is not served with this summons, to serve a notice of
appearance, on the Plaintiff's Attorney(s) within 20 days after the service of this summons, exclusive
of the day of service (or within 30 days after the service is complete if this summons is not personally
delivered to you within the State of New York); and in case of your failure to appear or answer, judgment
will be taken against you by default for the relief demanded in the complaint.

Dated, June , 1976

Defendant's address:
99 Church Street
New York, N.Y. 10007

PAUL, WEISS, RIFKIND, WHARTON & GARRISON
Attorney(s) for Plaintiff

Post Office Address
345 Park Avenue
New York, New York 10022
(212) 644-8000
MUNICIPAL ASSISTANCE CORPORATION 
FOR THE CITY OF NEW YORK, 

Plaintiff, 

-against-

MOODY'S INVESTORS SERVICE, INC., 

Defendant. 

Plaintiff Municipal Assistance Corporation For The 
City of New York ("MAC"), by its attorneys Paul, Weiss, Rifkind, 
Wharton & Garrison, complaining of defendant, alleges:

1. Plaintiff MAC, a public benefit corporation, 
is a corporate governmental agency and instrumentality of 
the State of New York, with principal offices at Two World 
Trade Center, New York, New York.

2. MAC was created by acts of the New York State 
Legislature on June 10, 1975 to assist New York City in attempting to provide essential services to its inhabitants while meeting its obligations to the holders of New York City securities.

3. Among other activities, MAC issues and sells notes and bonds to the general public, to banks, to governmental pension funds, and others. In the period June 10, 1975 to date, MAC has issued and sold bonds and notes in an aggregate amount exceeding $3,800,000,000.
4. MAC's credit standing with the financial community and the investing public is of vital importance to its ability to function and to carry out its legislative mandate.

5. On information and belief, defendant Moody's Investors Service, Inc. ("Moody's") is a Delaware corporation, with its principal offices at 99 Church Street, New York, New York. Moody's is one of three national organizations whose ratings of bonds and other securities are widely followed and relied upon by the financial community and the investing public.

6. In June, 1975, Moody's and MAC entered into an agreement (the "Agreement") whereby, for a fee, Moody's undertook to make an examination of the quality and credit-worthiness of an initial issue of MAC bonds (the 1975 Series A Bonds); to assign a rating to such bonds on the basis of such examination; to communicate such rating to MAC and thereafter to publish and disseminate such rating to the investing public; and to monitor and review such rating for a year following the sale of the bonds.

7. Moody's also agreed that during the succeeding year, upon request, an analysis and rating would be made of any subsequent issue of MAC bonds for a fee one-half that charged for rating the initial issue.
8. On or about July 2, 1975, Moody's announced that it had assigned a rating of "A" to MAC's 1975 Series A Bonds, and on August 12, 1975, it announced that it had assigned a rating of "A" to MAC's 1975 Series B Bonds.

9. Pursuant to the Agreement, MAC paid Moody's fees of $4,000 and $2,000, respectively, in connection with its ratings on MAC's 1975 Series A and Series B Bonds.

10. An "A" rating from Moody's is widely regarded by the financial community and investing public as a good rating. According to Moody's literature, bonds so rated "possess many favorable investment attributes and are to be considered as upper medium grade obligations."

FIRST CAUSE OF ACTION

11. By the Agreement, Moody's undertook to review and analyze MAC's bonds, and to monitor those bonds for a year, with due care, accuracy and professional skill. Indeed Moody's warranted that its examination and rating of bonds would be conducted under "the highest possible standards of professional competence for the financial community."

12. On May 26, 1976, Moody's flagrantly breached that key term of the Agreement, as follows:
13. On May 24, 1976, MAC publicly announced an exchange offer whereby holders of New York City short-term notes could exchange their notes for certain MAC bonds (the "Exchange Offer").

14. In a separate transaction, on May 25, 1976, MAC published an advertisement in major newspapers soliciting from the holders of Bonds issued under MAC's General Bond Resolution adopted July 2, 1975 certain consents (the "Notice"). The Notice clearly and conspicuously advised holders of such bonds to obtain and read an additional document called "Additional Information as to the Effects of the Adjustment Described in the Notice" issued by MAC and made widely available, which contains additional information concerning the consents being solicited and certain other information relevant thereto (the "Additional Information").

15. Briefly, the Notice solicited consents to proposed amendments of Sections 203 and 902 of MAC's General Bond Resolution pursuant to which the 1975 Series A and Series B Bonds were issued. The purpose of the amendments was to enable MAC to implement, and to facilitate the implementation of, the Amended and Restated Agreement of November 26, 1975 among MAC, certain banks, pension and sinking funds, for the restructuring of maturities and interest rates of MAC bonds held by those banks and funds.
16. In violation of the most elementary standards of professional care and competence, Moody's inexplicably omitted to obtain a copy of the Additional Information. Instead, Moody's completely misread the Notice and, relying upon that misreading alone, on May 26, 1975, Moody's precipitously downgraded its prior rating of MAC bonds from "A" to "B" -- a drop of three investment grades. Obligations rated "B," according to Moody's, "generally lack characteristics of the desirable investment."

17. Such a precipitous downgrading of a governmental agency's security is virtually unheard of in the financial community.

18. Moreover, in utter disregard of the customary practice in the profession, and despite Moody's own prior statements to MAC concerning the "complexity and amount of work" involved in analyzing MAC's bonds, Moody's failed even to attempt to speak to MAC concerning the facts of the Notice and Additional Information before taking the extraordinary and hasty step of precipitously downgrading MAC's bonds.

19. Furthermore, the report which Moody's issued in connection with its rating change makes it clear that the downgrading -- which was not concurred in by the other major
rating services, Standard & Poor's and Fitch -- was based entirely on a misreading of the Notice and Moody's failure to follow the most basic standards of its profession. Thus, Moody's report contains numerous errors, among which are the following:

(a) Moody's said that MAC was now "proposing" a restructuring of its bonds held by banks, pension and sinking funds, and that such restructuring "raise[s] serious questions as to the security of" MAC's bonds.

In fact, as Moody's knew, the restructuring was agreed to by MAC, the banks, sinking and pension funds, and announced, six months ago, as part of the aforesaid Amended and Restated Agreement of November 26, 1975 -- about which Moody's knew and never before expressed any concern -- and, in fact, the restructuring has no detrimental effect whatsoever on the security of MAC's bonds.

(b) Moody's said that "without [the restructuring and the amendments for which consents were solicited] MAC would not have sufficient revenues to meet its coverage requirements and comply with debt limits, and would not be able to carry out its agreement with New York City."

In fact, the restructuring and proposed amendments have no material effect on MAC's ability to meet its coverage requirement and comply with its debt limit.
Moody's knew or should have known from publicly available information -- and had Moody's obtained a copy of the Additional Information, it would have seen clearly -- that MAC's coverage requirements are ample with or without the restructuring and proposed amendments.

In fact, there is no "agreement with New York City" as stated by Moody's.

(c) Moody's said, quoting entirely out of context from the Notice, that "Without such amendments [MAC] could not carry out certain terms of the [Amended and Restated Agreement of November 26, 1975] without being in default under the [General Bond Resolution]."

In fact, as the Notice makes clear, (i) consent of only two-thirds of the holders of bonds issued under the General Bond Resolution is required, (ii) the banks, pension and sinking funds that are signatories to the November 26 agreement, and the State of New York, together hold two-thirds of such bonds, and (iii) MAC has no reason to expect that all of those holders would not give the requested consents. Thus, Moody's statement is at the very least misleading in its omission of these critical facts.

(d) Moody's said that the revocation period for the solicited consents is 120 days, and that this creates a long period of uncertainty for holders of New York City notes who are considering the Exchange Offer.
In fact, as clearly stated in the Notice, the consents may be revoked only up to the time when the Trustee of the MAC bonds gives notice to MAC that the requisite percentage of consents has been received. Since, as stated in the Notice, MAC has requested that consents be given by June 10, 1976, and expects that the Trustee will receive the requisite percentage of consents by that date, there is no long period of uncertainty.

(e) Moody's said that "there have been suggestions by governmental officials in the City and MAC that bankruptcy is a desirable alternative and for the City."

In fact, no such suggestion has been made by any MAC official.

(f) Moody's said that the prospect of bankruptcy action by the City "would certainly involve the MAC financing."

In fact, MAC is not dependent upon the New York City government or budget for its revenues. Rather, its revenues are derived entirely from State sources, principally State sales and use taxes which are appropriated by the State, not the City. The New York Supreme Court has upheld the constitutionality of the legislation imposing such State sales and use taxes within the City, and has directed the State Tax Commissioner to collect the sales and use taxes and remit the proceeds to MAC as required by such legislation. Thus, City bankruptcy would not deprive MAC of the revenue sources which are the security for its bonds.
20. In sum, Moody's downgrading of MAC's bonds was the result of its egregious misreading of the Notice; its failure to obtain and read the Additional Information; its failure to seek or obtain any information from MAC or appropriate legal advice; and its failure to follow elemental standards of prudence, competence and professionalism.

21. In consequence, Moody's downgrading of MAC's bonds constitutes a material breach of the warranties in the Agreement, including the warranty that Moody's would act under "the highest possible standards of professional competence for the financial community."

22. By reason of Moody's breach of contract, MAC has been injured in at least the following respects:

(a) MAC's credit standing has been impaired, and the market prices of its bonds plummeted upon release of Moody's change in rating;

(b) the success of the Exchange Offer has been jeopardized due to New York City noteholders' concern over the safety and credit-worthiness of MAC bonds which was engendered by Moody's change in rating; and
(c) MAC had proposed to issue and sell a series of "mini" bonds in July, 1976 and, as a consequence of Moody's actions, the interest rate required to be paid by MAC on such bonds may be substantially higher than previously anticipated.

23. MAC is entitled to recover at least the following amounts by way of damages:

(a) $6,000 paid to Moody's pursuant to the Agreement;

(b) a sum exceeding $ ______ representing printing, legal, advertising and other costs incurred by MAC in connection with the Exchange Offer which may now have been frustrated by Moody's action;

(c) a sum which cannot presently be determined representing increased interests costs for the proposed "mini" bonds; and

(d) a sum which cannot presently be determined but which is estimated to exceed $ ______ million, representing the damage to MAC's credit standing.

SECOND CAUSE OF ACTION

24. Plaintiff repeats and realleges paragraphs 1-23 hereof.
25. At all relevant times, Moody's held itself out to MAC and the public as a financial reporting and rating service possessing the requisite professional skill, knowledge and experience to review, analyze and rate, with care and accuracy, the bonds of governmental agencies, and to prepare complete and accurate reports thereon, in accordance with generally accepted standards and practices in the profession.

26. In its downgrading of MAC's bonds, Moody's acted recklessly, unprofessionally, and in gross violation of the standards of care customarily practiced by financial reporting and rating services and prevalent in the financial community.

27. As a consequence of Moody's tortious conduct, MAC has been damaged in at least the respects set forth in paragraph 22 hereof, and it is entitled to recover damages as set forth in paragraph 23 hereof.

WHEREFORE, MAC demands judgment against Moody's in an amount which cannot presently be determined but which
Congress $5,000,000,000, together with the costs and disbursements of this action.

Dated: June 30, 1976.

PAUL, WEISS, RIPKIND, WHARTON & GARRISON
Attorneys for Plaintiff
345 Park Avenue
New York, N.Y. 10022
644-8000