Comments and Notes

DIRKS, DEFINING THE SCOPE OF RULE 10b-5

I. INTRODUCTION

Insider trading occurs when a corporate insider[1] trades with knowledge of material nonpublic information concerning a company's stock. Insider trading is governed by Rule 10b-5,[2] promulgated by the Securities and Exchange Commission (SEC) pursuant to section 10(b) of the Securities Exchange Act of 1934.[3]

Under Rule 10b-5, persons with knowledge of material nonpublic information must either disclose such information or refrain from trading.[4] This prohibition against insider trading is firmly established under the antifraud provisions of the federal securities laws.[5] However, despite this general acceptance, the parameters of the law of insider trading remain poorly-defined.[6] Since neither section 10(b) of the Securities Exchange Act of 1934, nor Rule 10b-5 promulgated thereunder expressly prohibits insider trading,[7] current law remains almost entirely a product of administrative and judicial construction.[8]

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1. The term "insider" encompasses all persons "in a special relationship with a company and privy to its internal affairs . . . ." *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).

2. Rule 10b-5 in pertinent part provides:

> It shall be unlawful for any person, directly or indirectly . . .
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> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> (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 (1983).

3. Section 10(b) of the Securities Exchange 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 Commission may prescribe . . . ." 15 U.S.C. § 78j(b) (1982).

4. *Cady, Roberts*, 40 S.E.C. at 911; *see* Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, 70 CALIF. L. REV. 1, 1 (1982) [hereinafter cited as Langevoort].

5. *See* Chiarella v. United States, 445 U.S. 222, 227 (1980); *Cady, Roberts*, 40 S.E.C. at 912; Langevoort, *supra* note 4, at 1.

6. *See Chiarella*, 445 U.S. at 226.

7. *See supra* notes 2-3.

8. *See* Langevoort, *supra* note 4, at 3. *See also* Diamond v. Oreamuno, 24 N.Y.2d 494, 502, 248 N.E.2d 910, 914, 301 N.Y.S.2d 78, 84-85 (1969).

This note will discuss the United States Supreme Court opinion in *Dirks v. SEC.*[9] In *Dirks*, the Supreme Court found no actionable violation of the antifraud provisions of the federal securities laws, even though petitioner disseminated material nonpublic information obtained from an insider.[10] Justice Powell, writing for the majority, stated that a tippee's[11] duty to disclose or abstain is derivative from that of the insider's duty.[12] The Court went on to hold that there must be a breach of an insider's fiduciary duty before the tippee inherits the duty to disclose or abstain.[13] The Court found that the tipper-insider, from whom petitioner obtained the information, was motivated by a desire to expose fraud; he received no monetary or personal benefit from revealing the information, and did not intend to make a gift of valuable information to the petitioner.[14] For the above reasons, the Court found there was no breach of the tipper's fiduciary duty to the corporation and thus there was no derivative breach by the petitioner.[15]

II. BACKGROUND

At common law, corporate officers and directors were regarded as standing in a fiduciary relation to their corporation when dealing with corporate property.[16] However, there was no fiduciary duty to stockholders when engaging in transactions involving the corporation's stock.[17] As agents of the entity, corporate officers and directors owed

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9. *Dirks*, 103 S.Ct. 3255 (1983).

10. *Id.* at 3267-68.

11. A tippee is a person who is given information by insiders in breach of trust. *See* Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967).

12. *Dirks*, 103 S.Ct. at 3264.

13. *Id.* at 3266.

14. *Id.* at 3266-68.

15. *Id.* at 3268.

16. *See* DuPont v. DuPont, 242 F. 98, 136 (D. Del. 1917), *cert. denied*, 250 U.S. 642 (1919) ("[T]o the corporation [and] the whole body of stockholders, [the director] stands in a fiduciary relation which requires him to exercise the utmost good faith in managing its business affairs . . . ."); Empire State Sav. Bank v. Beard, 88 N.Y. Sup. Ct. (81 Hun.) 184, 191, 30 N.Y.S. 756, 760 (1894) ("Although directors undoubtedly stand in the position of agents, and cannot bind their companies beyond the limits of their authority, they also stand in some degree in the position of trustees . . . .").

17. *See DuPont*, 242 F. at 136 (director occupies no relation of trust to an individual stockholder which prohibits his using whatever advantage his position may afford him); Haarstick v. Fox, 9 Utah 110, 33 P. 251 (1893), *aff'd*, 156 U.S. 674 (1895) (court approved the rule that there is no confidential relation between an officer of a corporation and an individual stockholder so far as a sale of stock between them is concerned); Krumbhaar v. Griffiths, 151 Pa. 223, 25 A. 64 (1892) (in which the view of the master that "no special confidential or fidiciary relation" existed between

fiduciary duties to their corporation to preserve its assets and maintain its secrets.[18] Since nonpublic corporate information was not considered to be a corporate opportunity or asset, officers and directors were not precluded by their fiduciary duties from trading in the corporation's stock on the basis of this information.[19] Thus, because officers and directors did not stand in a fiduciary relation to the individual shareholders, they were free to trade with shareholders without disclosing nonpublic information affecting the value of the traded stock.[20]

In 1903 and 1904, the supreme courts of both Georgia[21] and Kansas[22] recognized an independent fiduciary duty running from the corporate officers and directors to individual shareholders with whom they traded in the corporation's stock. These courts held that an officer or director is a "quasi[-]trustee as to the shareholder's interest in the shares."[23] They further held that although an officer or direc-

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a director and a stockholder was approved); Gillet v. Bowen, 23 F. 625 (C.C.D. Colo. 1885) (*dictum* to the effect that trust relations of directors to the corporation do not as to stockholders "create trust relations *inter sese*"). *See also* RESTATEMENT (SECOND) OF AGENCY § 200 comment a, § 201 comment b (1936); 84 A.L.R. 616 (1933).

18. *See* Walsh v. Goulden, 130 Mich. 531, 539, 90 N.W. 406, 410 (1902) (directors stand in a fiduciary relationship to the corporation itself; they do not stand in that relation, however, when dealing with other stockholders for the purchase or sale of stock). *See also supra* note 16. RESTATEMENT (SECOND) OF AGENCY § 395 (1976); RESTATEMENT OF RESTITUTION § 200 comment a, § 201 comment b (1936).

19. *See* Board of Commissioners of Tippecanoe County v. Reynolds, 44 Ind. 509,513, 516 (1873) (where the purchase of stock was upheld when a director, who had knowledge, by reason of his position, that the true value of the company's stock was much greater than its nominal market value, purchased such stock from a stockholder who was ignorant of the true worth, without disclosing to the seller the extent of his knowledge). *See also supra* notes 17 & 18.

20. The Delaware Court of Chancery, as late as 1949, remarked that "in the absence of special circumstances, corporate officers and directors may purchase and sell its capital stock at will, and without any liability to the corporation." Brophy v. Cities Serv. Co., 31 Del. Ch. 241, 245, 70 A.2d 5, 8 (1949). *See also supra* notes 17-19.

21. Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903) (wherein the principle that a director has the duty to disclose pertinent facts to a shareholder was applied to invalidate a purchase of shares by a director at $110 per share, he having concealed the fact that a sale of the entire plant was contemplated at a price which would make the stock worth from $140 to $185 per share).

22. Stewart v. Harris, 69 Kan. 498, 77 P. 277 (1904) (wherein the president and the general manager of a corporation, without disclosing the true state of the corporate affairs and finances, bought stock worth $350 at $166, and, after procuring practically all the stock, declared a dividend of 120%).

23. *Oliver*, 118 Ga. at 367, 45 S.E. at 233. The court went on to say: "No process of reasoning and no amount of argument can destroy the fact that the director is, in a most important and legitimate sense, trustee for the stockholder." *Id.*; *see Stewart*, 69 Kan. at 504, 77 P. at 280; *see also* Hotchkiss v. Fischer, 136 Kan. 530, 16 P.2d 531 (1932) (where it was held that directors act in a fiduciary capacity in the management of corporate affairs, and that a director negotiating with a

tor is not forbidden to deal with shareholders, his relationship of trust requires him to "inform such stockholders of the true conditions of the affairs of the corporation" before trading with them.[24]

In 1909, the Supreme Court of the United States adopted the fiduciary principle of disclosure in *Strong v. Repide*.[25] In time, it became an established tenet of federal law under Rule 10b-5 that insiders owe a duty of disclosure, based on their fiduciary duty to the shareholders, when engaging in face-to-face purchases or sales.[26] The affirmative disclosure rule established by these cases is best seen "as the legal judgment that a person in a position of responsibility for the property or welfare of another should act in that capacity solely for the benefit of the beneficiary—in other words—a rule derived from the fiduciary's duty of loyalty."[27]

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shareholder for the purchase of shares acts in a relation of scrupulous trust and confidence). The Supreme Court of the United States in Jackon v. Ludeling, 88 U.S. (21 Wall.) 616, 624-25 (1874), held that the managers and officers of a company, where capital is contributed in shares, are in a very legitimate sense trustees, alike for its stockholders and its creditors, though they may not be trustees technically and in form. *See also* Sargent v. Kansas Midland R.R. Co., 48 Kan. 672, 29 P. 1063 (1892).

> The directors are persons selected to manage the business of the company for the benefit of the shareholders. It is an office of trust, which, if they undertake, it is their duty to perform fully and entirely. No director . . . can use his official position to secure a personal advantage to himself.

Id. at 688, 29 P. at 1069.

24. *Stewart*, 69 Kan. at 508, 77 P. at 281. *See Oliver*, 118 Ga. at 368, 45 S.E. at 234 ("If . . . the fact within the knowledge of the director is of a character calculated to affect the selling price, and can, without detriment to the interest of the company, be imparted to the shareholder, the director, before he buys, is bound to make a full disclosure.").

25. 213 U.S. 419 (1909). The Court set aside a purchase of stock by a director on the ground that he had failed to disclose to the shareholder-seller material facts bearing upon the value of the stock.

26. *See, e.g.*, Rogen v. Ilikon Corp., 361 F.2d 260, 268 (1st Cir. 1966). Wherein the court enumerated options open to a corporation and directors when dealing with a stockholder during crucial negotiation stages with another party: "(1) to refuse to disclose and refrain from buying during negotiations; (2) to disclose and attempt to buy during negotiations; and (3) if it clearly appears that the selling stockholder is in no way relying on nondisclosure, to take a chance on litigation . . . ." *See also* Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963) ("corporate insiders must scrupulously disclose to outsiders those material facts about a corporation's business which in reasonable and objective contemplation might affect the value of the corporation's stock . . . ."); Speed v. Transamerica Corp., 99 F. Supp. 808, 828-29 (D.C. Del. 1951) ("The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed . . . stockholders. It is an attempt to provide some degree of equalization of bargaining position . . . ."). *See* Langevoort, *supra* note 4, at 5.

27. Langevoort, *supra* note 4, at 5. *See generally* Scott, *The Fiduciary Principle*, 37 CALIF. L. REV. 539 (1949).

The fiduciary principle continued to provide an adequate standard to compel disclosure in face-to-face dealings between insiders and shareholders.[28] However, it became increasingly apparent that the fiduciary theory was unsuitable for compelling disclosure in an anonymous marketplace such as a stock exchange.[29] In contrast to face-to-face transactions, people neither know nor care who their buyers and sellers are in an anonymous market.[30] In effect, insiders were free to reap profits and avoid losses by using information to their advantage in trading on an exchange.[31]

The concept of a duty to disclose or refrain from trading in an impersonal market was established in the SEC's seminal decision in *In re Cady, Roberts & Co.*[32] The case turned on a determination of the nature of the duties of a selling broker after he received material nonpublic information pertaining to a company's dividend action from a corporate director, who was also a partner of the brokerage firm.[33] The Commission declared that insider trading in the impersonal market was a violation of Rule 10b-5.[34]

The obligation to disclose such material nonpublic information by corporate insiders rests on two principal elements.[35] First, the existence of a relationship affording access, directly or indirectly, to information intended to be available only for a corporate purpose. Second, "the inherent unfairness" involved where a party takes advantage of such information knowing it is unavailable to those with whom

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28. Langevoort, *supra* note 4, at 7.

29. *Id.*

30. *Id.*

31. *Id.* at 8.

32. *Cady, Roberts*, 40 S.E.C. at 907.

33. *Id.* In *Cady, Roberts*, one of the partners of the brokerage firm was also a director of the Curtis-Wright corporation. During a meeting of the board of directors, it was decided to reduce the rate of dividends on Curtis-Wright stocks. After this decision was made, and before such information was made public, this partner tipped off the brokerage firm as to the dividend cut. Upon receiving such information, the firm entered sell orders for its accounts at a price of approximately 40¼. Once this information was made public, the Exchange was compelled to suspend trading in Curtis-Wright because of the large number of sell orders. Trading was resumed and closed at 34⅞. *Id.* at 908-10.

34. *Id.* at 911. The commission 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. Failure to make such disclosure in these circumstances constitutes a violation of the antifraud provisions." *Id.* The court found that the partner's position as a corporate director "clearly prohibited him from selling the securities affected by the information without disclosure." The court extended this prohibition to the partner's associates in the brokerage firm. *Id.* at 912.

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

he is dealing.[36] Accordingly, the duty to disclose arises when one party has information "that the other is entitled to know because of a fiduciary or other similar relation of trust or confidence between them."[37] Hence, in *Cady, Roberts*, the Commission recognized the existence of a relationship of trust and confidence between the shareholders and those insiders who had obtained confidential information by reason of their position with that corporation.[38] Furthermore, the Commission extended this concept to those persons who acquired such confidential information from the insider and who were aware of the insider's relation of trust and confidence with the shareholders of that corporation.[39]

The Second Circuit approved this reasoning in *SEC v. Texas Gulf Sulphur*,[40] which declared that not only are directors and officers of a corporation insiders, but anyone in possession of material inside information must either disclose it to the investing public or abstain from trading.[41] Furthermore, the court asserted that the purpose of the Securities Exchange Act is to prevent inequitable and unfair practices

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36. *Id.* A Supreme Court case which demonstrates similar reasoning as *Cady, Roberts* is Mosser v. Darrow, 341 U.S. 267 (1951). In *Mosser*, the Court asserted that:

> [t]hese strict prohibitions would serve little purpose if the trustee were free to authorize others to do what he is forbidden . . . . We think that which the trustee had no right to do he had no right to authorize, and that the transactions were as forbidden for the benefit of others as they would have been on behalf of the trustee himself.

Id. at 271-72. Likewise, the Supreme Court held in Jackson v. Smith, 254 U.S. 586 (1921), that "others who knowingly join a fiduciary in such an enterprise [which runs counter to his duties] likewise become jointly and severally liable with him . . . ." *Id.* at 589.

37. RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976). *See* James & Gray, *Misrepresentation—Part II*, 37 MD. L. REV. 488, 523-27 (1978).

38. *Cady, Roberts*, 40 S.E.C. at 911 ("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"). *See* 3 L. LOSS, SECURITIES REGULATION 1446-48 (2d ed. 1961); 6 *id.* at 3557-58 (1969 Supp.). *See generally* Note, *Rule 10b-5: Elements of a Private Right of Action*, 43 N.Y.U. L. REV. 541, 552-53 & n.71 (1968); Daum & Phillips, *The Implications of* Cady, Roberts, 17 BUS. LAW. 939, 945 (1962).

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

40. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969) (company officials purchased Texas Gulf Sulphur stock on the New York Stock Exchange with knowledge of a copper strike, before such information was even known by all members of the board of directors. These corporate officials were ordered to disgorge the illegally obtained profits). *See generally* Bromberg, *Corporate Information*: Texas Gulf Sulphur *and Its Implications*, 22 SW. L.J. 731 (1968); Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the* Texas Gulf Sulphur *Proceeding*, 51 VA. L. REV. 1271 (1965); Ruder, Texas Gulf Sulphur—*The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 NW. U. L. REV. 423 (1968).

41. *Texas Gulf Sulphur*, 401 F.2d at 848.

and to insure fairness in securities transactions, whether conducted face-to-face, over the counter, or on exchanges.[42] The court noted that Rule 10b-5 is based on the justifiable expectation that in the securities marketplace, all investors trading on impersonal exchanges have relatively equal access to material information.[43]

It was soon established that liability under Rule 10b-5 was not limited to trading by insiders themselves.[44] In *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*,[45] the Second Circuit found that tippees,[46] persons who receive material nonpublic information from corporate insiders, were subject to the "disclose or refrain" rule.[47]

The Supreme Court further extended the duty to disclose or refrain to people who were not traditional insiders in that they had no special access to information concerning the assets or plans of the corporations that issued the securities in which they traded.[48] These cases became known as "market information" cases as opposed to inside information cases, because the information at issue related solely to the market for the securities rather than their extrinsic value.[49]

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42. *Id.* at 847-48.

43. *Id.* at 848.

44. *See supra* note 36, *infra* notes 45-47 and accompanying text.

45. 495 F.2d 228 (2d Cir. 1974) (Merrill Lynch was given information about a pending decline in the earnings of Douglas Aircraft Co. in the course of Merrill Lynch's preparation for an underwriting of Douglas debentures. Merrill Lynch then passed this confidential information to certain favored institutional investors who sold before the information became public).

46. *Id.* at 237. *Cady, Roberts* itself was a "tippee" case. *See supra* note 32.

47. *Shapiro*, 495 F.2d at 237. "Tippees" of corporate insiders have been held liable under § 10(b) because they have a duty not to profit from the use of inside information that they know is confidential and know or should know came from a corporate insider. *Id.* at 237-38. The tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty. Subcommittees of the American Bar Association Section of Corporate, Banking, and Business Law, Comment Letter on Material Non-Public Information (Oct. 15, 1973), *reprinted in* BNA, Securities Regulation & Law Report No. 233, pp. D-1, D-2 (Jan. 2, 1974), *as cited in Chiarella*, 445 U.S. at 230 n.12.

48. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (bank employees purchased shares in a tribal trust fund from mixed-blood Ute Indians without disclosing that there was a secondary market for the shares, at higher prices, among non-Indians); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) (investment adviser purchased stock for his own account just prior to publishing a recommendation that his clients buy the stock).

49. *Dirks*, 681 F.2d at 834. *See generally* Fleischer, Mundheim & Murphy, *An Initial Inquiry Into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798 (1973) [hereinafter cited as Fleischer]. "[M]arket information refers to information about events or circumstances which affect the market for a company's securities but which do not affect the company's assets or earning power." *Id.* at 799. *See also* Reed v. Riddle Airlines, 266 F.2d 314, 315, 319 (5th Cir. 1959) (insider failed to

The preceding decisions did not clearly indicate what circumstances trigger the duty to disclose or refrain from trading.[50] It appears that two theories emerged, the fiduciary theory and the information theory. The fiduciary theory focuses on the unfairness and fraud resulting from the conflicts of interest on the part of insiders or their tippees who profit at the expense or to the exclusion of those who have placed their trust in them.[51] The information theory follows from the notion that all investors should have equal access to information that a reasonable investor would consider material to investment decisions; and, that any trade in which only one party had an opportunity to learn, and did learn such information, is inherently unfair.[52]

In *Investors Management Co.*,[53] the Securities and Exchange Commission used the information theory to find investment advisers in

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disclose that a wealthy individual was interested in purchasing shares, where those purchasers caused an increase in price of the stock); Fleischer, *supra*, at 799 n.4.

50. *See, e.g., Texas Gulf Sulphur*, 401 F.2d at 851-52 (anyone who trades with information intended to be available only for a corporate purpose or communicates such information to others who are likely to trade prior to public disclosure is in violation of Rule 10b-5). *Id.; see also Cady, Roberts*, 40 S.E.C. at 912 (tippees and insiders have a duty to disclose or refrain from trading when they obtain information "intended to be available only for a corporate purpose and not for the benefit of anyone"); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228 (2d Cir. 1974) (no duty to disclose is triggered if tippee neither knows or should have known of the information's nonpublic nature); Investors Management Co., 44 S.E.C. 633 (1971) (the duty to disclose is triggered when the tippee receives material information which he knows or has reason to know has been improperly obtained and is of a nonpublic nature).

51. *Dirks*, 681 F.2d at 834-35; *see, e.g., Shapiro*, 495 F.2d at 228; *Texas Gulf Sulphur Co.*, 401 F.2d at 833; General Time Corp. v. Tally Indus., Inc., 403 F.2d 159 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969); Blazer v. Black, 196 F.2d 139 (10th Cir. 1952). However, the United States Supreme Court has stated, with regard to the fiduciary theory relationship, that not all breaches of a fiduciary duty will fall within the ambit of Rule 10b-5. *See* Santa Fe v. Green, 430 U.S. 462 (1977) (a breach of a fiduciary duty without deception or manipulation is non-actionable under 10b-5). *See also* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (no cause of action for damages will lie under 10b and 10b-5 in the absence of scienter); Biesenbach v. Guenther, 588 F.2d 400 (3d Cir. 1978) (violation of fiduciary duty does not, standing alone, constitute a cause of action under Rule 10b-5); Wright v. Heizer, 560 F.2d 236 (7th Cir. 1977) (breach of fiduciary duty and gross unfairness are not sufficient to establish liability without proof of deception or nondisclosure of material facts).

52. *Dirks*, 681 F.2d at 835. *See also* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963); Gratz v. Claughton, 187 F.2d 46 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951). *But see* Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 809 (1980) [hereinafter cited as Scott] (Scott argues that "fairness" rationale has "little substance").

53. 44 S.E.C. 633 (1971).

violation of the antifraud provisions of Rule 10b-5. In this case, investment advisers received nonpublic information from the brokerage firm of Merrill Lynch, Pierce, Fenner & Smith (Merrill Lynch) concerning a sharp decline in the earnings of Douglas Aircraft Co. (Douglas).[54] Based on this information, the investment advisers sold their Douglas stock, causing a sharp decline in the market price.[55]

The Commission found that the investment advisers had violated the antifraud provisions of Rule 10b-5 by trading on information which was material[56] and nonpublic, and which they knew or had reason to know was nonpublic and had been obtained improperly.[57] The Commission stated in its decision that

> a number of cases have not only established that the antifraud provisions embrace transactions by persons who occupy a special relationship to the issuer giving them access to nonpublic information, but have indicated that under certain circumstances they extend to transactions by others who have received such information as a result of its selective disclosure.[58]

The Commission recognized that the purpose of the federal securities laws is to maintain a fair and honest marketplace and to prevent inequitable and unfair practices within the market.[59] Therefore, any activity which adversely affects the marketplace is subject to scrutiny.[60] The Commission rejected contentions

> that no violation can be found unless it is shown that the recipient himself occupied a special relationship with the issuer or inside corporate source giving him access to non-public information, or in the absence of such relationship, that he had actual knowledge that the information was disclosed in a breach of fiduciary duty not to reveal it.[61]

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54. Merrill Lynch had acquired this information as a result of being the managing underwriter for Douglas debentures. *Id.* at 634. *See also* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228 (2d Cir. 1974).

55. 44 S.E.C. at 635-36.

56. The Commission held the factors to be considered in determining whether information is material "are the degree of its specificity, the extent to which it differs from information previously disseminated, and its reliability in light of its nature and source and the circumstances under which it was received." *Id.* at 642.

57. *Id.* at 641.

58. *Id.* at 639.

59. *Id.*

60. *Id.* By utilizing the information test, the Commission imposed tippee liability upon the investment advisors even though there was a lack of fiduciary duty. *Id.*

61. *Id.* at 643.

The United States Supreme Court sought to clarify any apparent conflict between the fiduciary theory and the information theory in the leading case of *Chiarella v. United States*.[62] Chiarella, an employee of a financial printer, handled documents containing information pertaining to tender offers. Even though the names of the target companies were concealed, Chiarella was able to ascertain the identity of the target companies from other information contained on the document. Chiarella bought stock in the target company before the offer was announced and subsequently sold his stock at a considerable profit.[63]

At the court of appeals level, the Second Circuit Court held that "*[a]nyone*—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose."[64] In reversing, the Supreme Court, per Justice Powell, noted that neither section 10(b), Rule 10b-5, nor the legislative history of either offers clear authority for imposing a disclose or refrain obligation on "anyone."[65] The Court then traced the progression of cases recognizing an obligation to disclose.[66] Justice Powell made it clear that rationalizing these cases requires recognition of a fiduciary duty. The Court stated that liability is premised upon a "duty to disclose arising from a relationship of trust and confidence between parties to a transaction."[67] Thus, the trust and confidence placed in the corporate management by the shareholder serves as a basis for prohibiting insider trading under section 10(b). The Court further noted that "[a]pplication of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's

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62. 445 U.S. 222 (1980) (Powell, J., delivered the opinion of the Court in which Stewart, White, Rehnquist, and Stevens, J.J., joined. Stevens, J., filed a concurring opinion. Brennan, J., filed an opinion concurring in the judgment. Burger, C.J., filed a dissenting opinion. Blackmun, J., filed a dissenting opinion in which Marshall, J., joined.).

63. *Id.* at 224.

64. United States v. Chiarella, 588 F.2d 1358, 1365 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980). *See* Note, *Rule 10b-5—Nontraditional Corporate Insiders in Possession of Material Inside Information Have a Duty Either to Disclose the Inside Information or to Abstain From Trading in the Corporations Stock*, 47 GEO. WASH. L. REV. 965 (1979); Comment, *Rationalizing Liability for Nondisclosure Under 10b-5: Equal Access to Information and* United States v. Chiarella, 1980 WIS. L. REV. 162.

65. *Chiarella*, 445 U.S. 225-26.

66. *Id.* at 228-29. In its opinion, the Supreme Court discussed Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968); Cady, Roberts & Co., 40 S.E.C. 907 (1961).

67. *Chiarella*, 445 U.S. at 230.

welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information."[68]

In rejecting the Second Circuit's "regular access to market information" test,[69] the Court held that Chiarella was under no duty of disclosure to the public.[70] Justice Powell found that the court of appeals had "failed to identify a relationship between petitioner [Chiarella], and the sellers that could give rise to a duty."[71] Further, "not every instance of financial unfairness constitutes fraudulent activity under § 10(b)."[72] In addition, the Court noted it could not affirm Chiarella's conviction "without recognizing a general duty between all participants in market transactions to forgo actions based on material nonpublic information."[73] The Court observed that "[f]ormulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationshp between two parties, . . . should not be undertaken absent some explicit evidence of Congressional intent."[74]

The Court was unable to find any statutory support for the broad "disclose or refrain" rule advanced by the Second Circuit. The Court stated that "[s]ection 10(b) is aptly described as a catchall provision,

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68. The court did not limit the disclose or refrain obligation strictly to preexisting fiduciary relationships. In a footnote, the Court noted that "tippees" are subject to a duty to refrain from trading, *id.* at 230 n.12 (citing *Shapiro*, 495 F.2d at 237-38); *see supra* note 46; *see also* 445 U.S. at 227 n.8. (citing *Cady, Roberts*, 40 S.E.C. at 913 and Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951)).

Under the standard espoused by the Court, Chiarella was not a corporate insider. The element that is required to make silence fraudulent—the duty to disclose—is absent since he received no confidential information from the target company. No duty could arise from Chiarella's relationship with the sellers of the target company's securities because he had no prior dealings with them. Chiarella was not a fiduciary nor was he one in whom the sellers had placed their trust and confidence. *Chiarella*, 445 U.S. at 231, 232.

69. The Second Circuit's regular access to market information test was based upon the Congressional intent to "protect the integrity of the marketplace in which securities are traded." *Chiarella*, 588 F.2d at 1365 (citing United States v. Brown, 555 F.2d 336, 339 (2d Cir. 1977)). Under this test, anyone "who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose." *Id.* In its opinion, the Supreme Court noted that "neither the Congress nor the Commission ever has adopted a parity-of-information rule." *Chiarella*, 445 U.S. at 233.

70. *Chiarella*, 445 U.S. at 235.

71. *Id.* at 231-32.

72. *Id.* at 232. *But see* Scott, *supra* note 52.

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

74. *Id.*

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."[75] No such duty arises from the "mere possession of nonpublic market information."[76]

In a dissenting opinion, Chief Justice Burger read section 10(b) and Rule 10b-5 to mean "that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."[77] Hence, the duty to disclose or refrain would not turn upon the existence of a fiduciary relationship. Under Chief Justice Burger's standard, the duty to disclose or refrain from trading would be invoked "when an informational advantage is obtained, not by superior experience, foresight or industry, but by some unlawful mens."[78]

It is clear that the holding of *Chiarella* is narrow. The Supreme Court expressly rejected, as a matter of statutory construction, the notion that mere possession of nonpublic market information gives rise to a duty to disclose or refrain.[79] The Court emphasized that the "duty to disclose arises from a relationship of trust and confidence between parties to a transaction."[80] That the boundaries for insider trading are still unsettled is evidenced by the majority's action in reserv-

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75. *Id.* at 234-35.

76. In the final part of the opinion, the Court considered an alternative theory advanced by the United States to support Chiarella's conviction. The United States argued that Chiarella breached a duty to the acquiring company by misappropriating confidential information. The Court noted that this theory was not submitted to the jury. As a result, the Court did "not speculate upon whether such a duty exists, whether it has been breached, or whether such a breach constitutes a violation of § 10(b)." *Id.* at 235-37.

Several members of the Court acknowledged that the misappropriation of confidential information theory of liability is still unsettled. *Id.* at 238 (Stevens, J., concurring); *id.* at 239 (Brennan, J., concurring); *id.* at 243 (Burger, C.J., dissenting).

77. *Id.* at 240 (Burger, C.J., dissenting). *See* Keeton, *Fraud-Concealment and Non-Disclosure*, 15 TEX. L. REV. 1, 25-26 (1936).

78. *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting). In a separate dissent, Justice Blackmun, joined by Justice Marshall, found an even broader basis upon which to affirm the court of appeals decision than did the Chief Justice. Justice Blackmun would have held 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." Justice Blackmun emphasized that the Court's approach minimized "the importance of petitioner's [Chiarella's] *access* to confidential information that the honest investor no mater how diligently he tried, could not legally obtain." *Id.* at 251, 247 (Blackmun, J., dissenting).

79. *Id.* at 235.

80. *Id.* at 230.

ing for another case the "misappropriation theories" discussed by Chief Justice Burger and Justice Stevens.[81]

III. FACTS

Petitioner, Raymond L. Dirks, is a securities analyst. In March of 1973, he was an officer of a registered broker-dealer. Dirks, highly respected for his investigative talents, specialized in providing advice about the insurance industry.[82]

On March 6, 1973, Dirks was approached by Ronald Secrist, an employee who had recently been fired by a subsidiary of the Equity Funding Corporation of America (Equity Funding). Secrist informed Dirks that he had information concerning fraud and illegality at Equity Funding. More specifically, "Secrist alleged that the assets of Equity Funding, a diversified corporation primarily engaged in selling life insurance and mutual funds, were vastly overstated as a result of fraudulent corporate practices."[83] Secrist further contended that other Equity Funding employees had made similar charges to various regulatory agencies but the agencies had failed to act on them. Based on these allegations, and Secrist's urging that Dirks verify and publicly disclose the fraud, Dirks decided to investigate Equity Funding.[84]

Dirks was not able to discern anything conclusive from an inspection of publicly available data. Contact with people in the investment community proved fruitless, for most of them believed there was no truth to Secrist's allegations.[85]

On March 20, Dirks met with Patrick Hopper, a former vice-president of Equity Funding who had been Secrist's superior at Equity

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81. *Id.* at 241 (Burger, C.J., dissenting); *id.* at 238 (Stevens, J., concurring). *See also* Langevoort, *supra* note 4, at 16 (suggesting that *Chiarella* may in large part be a pleadings and jury instruction case).

82. *Dirks*, 103 S.Ct. at 3258.

83. *Id.* Secrist alleged that a subsidiary of Equity Funding has created false insurance policies and records to inflate its sales figures and was also selling partnerships in non-existent real estate; top officers of Equity Funding had Mafia connections which were used to threaten the lives of employees who objected to the fabrications; and that the accounting firm of Haskins & Sells had dropped the Equity Funding account due to disagreement with the company's accounting practices. (Dirks, through an informant, quickly discovered this allegation was untrue; Haskins & Sells lost the Equity Funding account to a competitor.) *Dirks*, 681 F.2d at 829-30.

84. *Dirks*, 103 S. Ct. at 3258. Secrist did not go to the SEC because he had heard that the SEC had repeated the information it had received from employees to Equity Funding's president. *Dirks*, 681 F.2d at 832 n.6.

85. *Dirks*, 681 F.2d at 830.

Funding's subsidiary. Hopper explained that although Secrist tended to exaggerate, he believed the gist of Secrist's allegations.[86] Hopper and Dirks sought out Frank Majerus, another former Equity Funding employee, who admitted his involvement in altering the company's insurance-in-force figures for 1970.[87]

On March 21, Dirks met with the top management of Equity Funding who denied that there was any impropriety at the company.[88] Dirks, seeking further corroboration of Secrist's allegations, contacted four other former or current Equity Funding employees. Independently, all four had come to the conclusion that Equity Funding's computer files contained large blocks of phony insurance policies.[89]

From Friday, March 23 through Monday, March 26, Dirks was continually in contact with members of the investment community. Dirks openly discussed the status of the investigation with anyone who inquired.[90] These were the last two full days on which Equity Funding stocks were bought or sold on the New York Stock Exchange. During this time, Dirks followed his customary practice of calling companies that he knew were interested in news concerning Equity Funding.[91] The record shows that many of those with whom Dirks spoke on or after March 20 sold their Equity Funding securities as quickly as possible. These companies sold approximately $15.5 million in Equity Funding stock and $41 million in convertible debentures

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86. During 1971, Hopper had been following Equity Funding's life insurance sales on a weekly basis until October, when the company stopped circulating weekly reports. When the year-end figures appeared in January, Hopper noticed that the final figure for life insurance sales was almost double what his running total had been in October. He also noted that the sales figures for what had previously been the best of the company's five sales districts, were far less than one-fifth of the total insurance sales figures for 1971.

Hopper also told Dirks that he attended a dinner in New York with several other Equity Funding officers who joked openly about "the Y business"—according to Secrist, the euphemism by which the insurance fabrication program was known within the company. *Id.* at 830.

87. *Id.*

88. *Dirks*, 103 S. Ct. at 3258.

89. *Dirks*, 681 F.2d at 830-31.

90. *Dirks*, 103 S. Ct. at 3258.

91. Dirks provided investment advice to a number of institutions that he knew had invested or might have been interested in investing in insurance company stocks. Dirks had no formal relationship with these institutions; he tried to remain aware of their investment strategies and objectives, informing them whenever he obtained information that he thought would be of interest. Under the custom of the industry, Dirks received no direct compensation from these clients. Instead, if they thought the information given to them by Dirks was valuable, they would direct some of their brokerage business through his firm, thus giving the firm an opportunity to earn brokerage commissions. *Dirks*, 681 F.2d at 829.

by the time the New York Stock Exchange halted trading in Equity Funding securities on March 27.[92]

It is not clear how many companies with whom Dirks spoke promised to direct brokerage business through his firm or how many actually did so. The record indicates that some of those with whom Dirks spoke did in fact use his firm as a broker for securities transactions during the ensuing weeks.[93]

While Dirks had been in Los Angeles investigating Equity Funding, he was regularly in contact with William Blundell, Los Angeles bureau chief for the *Wall Street Journal*. Dirks kept Blundell informed of the status of the investigation, urging him to write a story for the *Wall Street Journal* about the allegations of fraud at Equity Funding. Blundell, fearing such damaging rumors could be libelous, declined to write the story.[94] On March 26, Blundell contacted the SEC's Los Angeles office repeating what Dirks had told him, but the SEC took no immediate action.[95] On Tuesday, March 27, Dirks met with the

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92. Dirks spent several hours on the phone with officers of The Boston Company Institutional Investors on March 20, at one point putting Hopper on the line to repeat what he told Dirks and to further discuss Equity Funding. The following day The Boston Company sold all of its Equity Funding stock for over $7 million and all of its holdings of Equity Funding debentures for $575,000. Dirks' discussions with four other companies had the same result. John W. Bristol Co. alone sold more than $8 million worth of securities on March 26. *Id.* at 831 n.4. *See In re* Boston Co. Institutional Investors, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,705 (Sept. 1, 1978).

93. Representatives of The Boston Company explicitly told Dirks that they would direct $25,000 worth of commission business through his firm. *Dirks*, 103 S. Ct. at 3258 n.2. Earlier in Dirks' investigation, The Boston Company arranged to give the firm approximately $4,000 worth of brokerage commissions in return for the insurance company (Equity Funding) report and recommendation. *Dirks*, 681 F.2d at 831.

94. *Dirks*, 103 S. Ct. at 3258.

95. The SEC had a history of failing to act promptly in the Equity Funding case. In 1971, the SEC was approached by an Equity Funding employee who reported questionable accounting practices at Equity Funding. After performing a cursory investigation, the SEC took no further action.

On March 7, 1973, before meeting with Dirks, Secrist told his story to the New York State Insurance Commissioner's Office. They relayed the information to the California Insurance Department, which had jurisdiction over Equity Funding. On March 9, an official of the California Department had a conference with one of the staff attorneys in the SEC's Los Angeles office at which Secrist's charges were repeated. The California official stated that he thought his department might want to do a full inspection of Equity Funding, and he asked for help from the SEC. The SEC staff attorney stated that similar allegations had been made before by disgruntled employees of Equity Funding and recommended delaying any type of inspection until the next year when more personnel would be available. The attorney's memorandum to his superior was not written until March 16, and it was not read until after the SEC's interviews with Dirks had begun. *Dirks*, 681 F.2d at 832 n.6; *see* Meyer, *Equity Funding Woes Were Brought to SEC Weeks Before it Acted*, Wall St. J., Aug. 29, 1973, at 1, col. 2.

SEC and presented the information he had discovered about Equity Funding to the SEC staff. The SEC took no action against Equity Funding on Tuesday, but late that day the New York Stock Exchange halted trading in Equity Funding stock after a brokerage firm lodged a complaint of "disorderliness" in the market for the stock.[96] During the two-week period in which Dirks pursued his investigation and spread word of Secrist's charges, the price of Equity Funding stock fell from $26 per share to less than $15 per share.[97]

On Wednesday, March 28, the SEC suspended trading in Equity Funding securities for ten days. Later that week, the insurance departments of Illinois and California staged surprise inspections of Equity Funding. California authorities impounded Equity Funding's corporate records, and Illinois investigators discovered that $20 million in corporate bonds supposedly owned by Equity Funding did not exist.[98]

On April 2, the SEC filed a complaint against Equity Funding. The same day, the *Wall Street Journal* published a front page story written by Blundell based on the information he had obtained from Dirks. Equity Funding went into receivership, Blundell was nominated for a Pulitzer Prize for his coverage of the Equity Funding scandal, and Dirks became the object of the disciplinary proceeding on review in this case.[99]

After a hearing by an administrative law judge, the SEC found that Dirks aided and abetted in violation of section 17(a) of the Securities Act of 1933, section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder. The SEC contended that, regardless of their motivation or occupation, when tippees come into possession of material information that they know is confidential and know or should know came from a corporate insider, they must either publicly disclose that information or refrain from trading.[100]

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96. *Dirks*, 681 F.2d at 832.

97. *Dirks*, 103 S.Ct. at 3258.

98. These bonds accounted for approximately 70% of the assets of its major subsidiary. *Dirks*, 681 F.2d at 832. *See* Blundell, *A Scandal Unfolds: Some Assets Missing, Insurance Called Bogus at Equity Funding Life*, Wall St. J., Apr. 2, 1973, at 1, col. 6; at 14, col. 1.

99. *Dirks*, 103 S.Ct. at 3259.

100. *Id.* The SEC instituted a disciplinary proceeding that included Dirks and five sellers of Equity Funding securities to determine whether their conduct violated § 17(a) of the Securities Act of 1933, § 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 promulgated thereunder. The administrative law judge found violations of these antifraud provisions. Four of the institutional investors were sanctioned and it was recommended that Dirks be suspended from associating with a broker or dealer for a period of 60 days. Dirks filed a petition for review of the initial decision with the Commission claiming there was insufficient factual and legal basis for

On petition for review of the SEC's decision, a split panel of the Court of Appeals for the District of Columbia, Judge Tamm dissenting, issued a judgment without opinion denying the petition. However, on May 19, 1982, the court issued an opinion by Judge Wright in support of the judgment.[101]

IV. THE COURT OF APPEALS DECISION

At the outset of the opinion, Judge J. Skelly Wright, writing for the court, noted the conflicting issues of law and policy concerning the role of private securities analysts who investigate corporate fraud. The court recognized that securities analysts can provide an important source of information to the public while supplementing a frequently overburdened SEC staff and the press.[102] The court acknowledged that the threat of liability under Rule 10b-5 could inhibit the enthusiasm with which analysts conduct their investigations, but expressed the need to prevent private analysts from keeping the information they discover from the SEC while their clients "dump fraudulent securities on an uninformed public."[103]

Dirks argued that under *Chiarella*,[104] neither he nor his informants could be held to have violated Rule 10b-5 unless they breached some legal duty to Equity Funding requiring them to keep knowledge of its crimes secret.[105] The court of appeals rejected Dirks' assertion that neither California law nor any other law created such a duty.[106] The SEC's view, adopted by the court, was that Dirks aided and abetted violations of Rule 10b-5 by selectively disseminating inside information to investors who were likely to sell their Equity Funding stock without publicly disclosing what they learned from Dirks.[107]

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finding that he had violated Rule 10b-5. In response, the Division of Enforcement filed a petition seeking to increase the sanctions imposed on Dirks.

The Commission found that Dirks had aided and abetted violations of § 17(a) and rule 10b-5 but it rejected the division's request for increased sanctions. Expressing a desire not to impede investigative securities analysis, while recognizing Dirks' role in exposing the Equity Funding scandal and his unblemished reputation in the investment community, the Commission reduced the sanction imposed by the administrative law judge to a censure. *See In re* Boston Co. Institutional Investors, [1978 Transfer Binder] FED. SEC. L. REP. ¶ 81,705 (Sept. 1, 1978); *In re* Dirks, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,812.

101. *Dirks*, 103 S.Ct. at 3260.

102. *Dirks*, 681 F.2d at 829.

103. *Id.*

104. *Chiarella*, 445 U.S. 222 (1980).

105. *Dirks*, 681 F.2d at 838.

106. *Id.* at 838-39.

107. *Id.* at 837.

The court declined to decide whether the California courts would hold that the tippers breached their fiduciary duties by disclosing their information to Dirks, someone who might have foreseeably used the information to make a profit.[108] Instead, the court emphasized that although the standards of Rule 10b-5 approximate state fiduciary obligations, courts do not regard the two as identical.[109] Judge Wright noted that the *Chiarella* majority "focused on the existence of a set of fiduciary obligations as a prerequisite"[110] to imposing a duty to disclose or refrain.

Judge Wright maintained that even if Dirks' informants did not breach their fiduciary duties under California law,[111] Rule 10b-5 was applicable to this case. "No matter what standard of conduct state law sets, Rule 10b-5 may require those who are fiduciaries under state law to disclose material information they have learned during the course of their fiduciary relationships before trading in securities."[112] Judge Wright therefore concluded that since "the obligations of corporate fiduciaries pass to all those to whom they disclose their information before it has been disseminated to the public at large, . . . Dirks (and through him his clients) became subject to his informants' disclose-or-refrain obligation."[113] In other words, Dirks and his clients became tippees under the doctrine of *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*.[114]

The court rejected Dirks' contention that the information that he passed on to his clients did not constitute material facts. The obligation to disclose or refrain does not extent to everything a trader may know or believe. It applies only to material facts that have not yet

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108. *See id.* at 838 n.15.

109. *See* Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir. 1970), substituted opinion and rehearing *en banc* denied Mar. 2, 1971 (the court sustained a verdict that fiduciaries may violate Rule 10b-5 even if their actions do not violate their fiduciary duties defined by state law); Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978) (existence of parallel state remedies did not preclude application of Rule 10b-5).

110. *Dirks*, 681 F.2d at 838.

111. *Id.* at 639 (citing Staffin v. Greenberg, 672 F.2d 1196, 1202 (3d Cir. 1981)); United States v. Newman, 664 F.2d 12, 17-18 (2d Cir. 1981).

112. *Dirks*, 681 F.2d at 839. *See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228 (2d Cir. 1974); Investors Management Co., 44 S.E.C. 633 (1971).

113. *Dirks*, 681 F.2d at 839.

114. 495 F.2d 228 (2d Cir. 1974). One commentator points out: "Chiarella certainly suggests that in the absence of some affirmative and pre-existing relationship between an alleged aider and abettor and those who are allegedly injured by the aiders and abettor's silence or inaction. Rule 10b-5 liability simply may not exist." Pitt, Chiarella *Court: Limits on Novel 10b-5 Actions*, II Legal Times, Washington & C., No. 43 (Mar. 31, 1980), at 22.

been disseminated to the public.[115] The court applied the standard for materiality articulated by the Supreme Court in *TSC Industries, Inc. v. Northway, Inc.*,[116] which states that an omission is material if "the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[117] The court then found that a reasonable person could infer from the record the facts necessary to find a single violation of Rule 10b-5 by a preponderance of the evidence.[118] The court distinguished *SEC v. Monarch Fund*[119] which held that general rumors are not enough to support Rule 10b-5 liability and found that petitioner had enough specific information pertaining to the scheme at Equity Funding to make the information material.[120] The court appears to have adopted the view that since the unverified allegations were repeated by several Equity Funding employees, the information became specific enough to constitute material facts.

Finally, the court rejected Dirks' argument that the SEC applied the wrong scienter standard in finding that he aided or abetted his clients' violation of Rule 10b-5.[121] In order that Dirks be liable for aiding or abetting a violation of Rule 10b-5, he must have had a "general awareness that his role was part of an overall activity that was improper" and must have "knowingly and substantially assisted the principal violation."[122] The court found that Dirks had a duty to the public and to the SEC not to foster the sale of fraudulent securities. In light of the overwhelming evidence that "Dirks *knew* that

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115. *See Texas Gulf Sulphur*, 401 F.2d at 848-50; List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

116. 426 U.S. 438 (1976).

117. *Id.* at 449.

118. *Dirks*, 681 F.2d at 843.

119. 608 F.2d 938 (2d Cir. 1979). *See also* Hassig v. Pearson, 565 F.2d 644 (10th Cir. 1977); Marx & Co. v. Diners' Club, Inc., 550 F.2d 505 (2d Cir.), *cert. denied*, 434 U.S. 861 (1977).

120. 681 F.2d at 843. *Compare* Pachter v. Merrill Lynch, Pierce, Fenner & Smith, 444 F. Supp. 417 (E.D.N.Y.), *aff'd mem.* 594 F.2d 852 (2d Cir. 1978). Broker who heard rumors of fraud at Equity Funding did not have a duty to disclose them to a client who submitted an unsolicited "buy" order on March 27, 1973.

121. *Dirks*, 681 F.2d at 846.

122. Investors Research Corp. v. SEC, 628 F.2d 168, 178 (D.C. Cir.), *cert. denied*, 449 U.S. 919 (1980); Woodward v. Metro Bank of Dallas, 522 F.2d 84, 94-95 (5th Cir. 1975). The *Investors Research-Metro Bank* test has three elements: "1) Another party has committed a securities law violation; 2) the accused aider and abettor had a general awareness that his role was part of an overall activity that was improper; and 3) the accused aider and abetter knowingly and substantially assisted the principal violation." 628 F.2d at 178.

any Equity Funding securities on the market were fraudulent or worthless,"[123] the court rejected as meritless Dirks' contention that he could not be liable as an aider or abettor.[124] The court found that Dirks knowingly took improper actions by providing his clients with the Equity Funding information, thereby putting parties who were reasonably likely to trade without such disclosure in a position to do so.[125] This was deemed sufficient to support a finding that Dirks acted with the requisite scienter for imposing liability as an aider and abetter under Rule 10b-5.[126]

It is apparent that the appellate court found public policy a compelling reason to impose liability on Dirks. Judge Wright concluded that Dirks had obligations to the SEC and the public which were completely independent of any obligations acquired under the doctrine of tippee liability.[127] These obligations were said to be implicit in the scheme of broker-dealer registration under the federal securities laws, a scheme which gives rise to a duty to disclose or refrain even in circumstances where no such duty would be imposed on Dirks' sources at Equity Funding.[128] The court concluded that the primary purpose of SEC regulation of broker-dealers was to ensure that broker-dealers "treat their customers honestly and fairly."[129] In addition, the court of appeals cited the fact that the Supreme Court has held repeatedly that the scheme of federal securities regulation "has as a major objective 'to achieve a high standard of business ethics . . . *in every facet of the securities industry*.'"[130] The court then held that Dirks had violated his duties to the SEC and to the public by failing to inform the SEC of the ongoing fraud at Equity Funding.[131]

V. UNITED STATES SUPREME COURT DECISIONS

The Supreme Court began its analysis by reviewing the duty to disclose or refrain concept which originated in the seminal case of *In re Cady, Roberts*.[132] There, the Court noted, the SEC declared that a

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123. *Dirks*, 681 F.2d at 845 n.28.

124. *Id. See* Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 167-68 (2d Cir. 1980) (scienter standard in rule 10b-5 satisfied when corporate officers knowingly disclosed information they knew was material and not public to one who might "reasonably be expected to use it to his advantage").

125. *Dirks*, 681 F.2d at 846.

126. *Id.*

127. *Id.* at 840.

128. *Id.*

129. *Id.*

130. *Id.* (quoting United States v. Naftalin, 441 U.S. 768, 775 (1979)).

131. *Dirks*, 681 F.2d at 842.

132. *Cady, Roberts*, 40 S.E.C. 907 (1961).

corporate insider must refrain from trading in the shares of his corporation unless he has disclosed all material inside information known by him.[133] The Supreme Court then articulated the elements of a Rule 10b-5 violation as set forth in *Cady, Roberts* and subsequently approved by the Court in *Chiarella*: "(i) the existence of a relationship affording access to inside 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."[134]

Justice Powell noted that in *Chiarella* the Supreme Court declared that the duty to disclose under Rule 10b-5 arises not from the mere possession of nonpublic market information[135] but rather from the existence of a fiduciary relationship between the trader and the corporation and its shareholders.[136] The Court, however, made clear that not every breach of this fiduciary duty constitutes a violation of Rule 10b-5.[137] There must also be "manipulation" or "deception."[138] The Court noted that in an inside-trading situation, "fraud derives from the 'inherent unfairness involved where one takes advantage' of 'information intended to be available only for a corporate purpose and not for the personal benefit of anyone.'"[139] Thus, under Rule 10b-5, an insider will be liable only when he fails to disclose material nonpublic information before trading on it and makes secret profits.[140]

In *Dirks* the Supreme Court indicated its unwillingness to dispense with the requirement of a fiduciary relationship as a prerequisite for imposing liability under Rule 10b-5. The Court noted that not requiring a fiduciary relationship would depart from the established doctrine that duty arises from a specific relationship between parties.[141]

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133. *Dirks*, 103 S. Ct. at 3260; 40 S.E.C. 907, 911 (1961). For a more detailed discussion of *Cady, Roberts*, see *supra* notes 32-39 and accompanying text.

134. *Dirks*, 103 S. Ct. at 3260 (quoting *Chiarella*, 445 U.S. at 227.

135. *Dirks*, 103 S. Ct. at 3260-61; *Chiarella*, 445 U.S. at 227.

136. *Dirks*, 103 S. Ct. at 3261; *Chiarella*, 445 U.S. at 227-35.

137. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977) (claim of fraud and fiduciary breach states a cause of action under Rule 10b-5 only if the conduct alleged can be fairly viewed as "manipulative or deceptive" within the meaning of the statute). *See supra* note 51.

138. *Dirks*, 103 S. Ct. at 3261.

139. *Id. See In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 936 (1968).

140. *Dirks*, 103 S. Ct. at 3261. *See Cady, Roberts*, 40 S.E.C. at 916 n.31.

141. *Dirks*, 103 S. Ct. at 3261. The court stated that

> "[n]ot to require such a fiduciary relationship . . . would 'depar[t] radically from the established doctrine that duty arises from a specific relatonship between two parties' and would amount to 'recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information.' " *Id.* (quoting *Chiarella*, 445 U.S. at 232-33).

According to the Court, the effect of dispensing with the fiduciary requirement would result in creating a general duty between all participants in a market transaction.[142]

The Court recognized that the requirement of a specific relationship between shareholders and one who trades on inside information has led to analytical difficulties for the SEC and the courts in determining when a tippee acquires the *Cady, Roberts* duty to disclose or abstain from trading on inside information.[143] Justice Powell observed that unlike insiders who have fiduciary duties to the corporation and its shareholders, a tippee commonly has no such relationship.[144] Thus, the Court set out to clarify how the duty to disclose or abstain from trading, as espoused in *Cady, Roberts*, is acquired by a tippee.

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142. *Id.*

143. *Id.* at 3261-62.

144. *Id.* at 3261. The Court recognized that certain outsiders such as underwriters, accountants, lawyers, or consultants may become fiduciaries of the shareholders when they legitimately receive corporate information. The basis for this fiduciary duty is not that such outsiders have acquired nonpublic corporate information, but rather "that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes." *Id.* at 3261 n.14. *See* SEC v. Monarch Fund, 608 F.2d 938, 942 (2d Cir. 1979); Investors Management Co., 44 S.E.C. at 645; *in re* Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 937 (1968); *Cady, Roberts*, 40 S.E.C. at 912.

The Supreme Court's logic was applied in SEC v. Lund, [Current] FED. SEC. L. REP. (CCH) ¶ 99,495 (C.D. Cal. Sept. 16, 1983). In *Lund*, the defendant was a friend and business associate of a corporate insider. The two often exchanged information about their corporations. In this case, information was made available to the defendant solely for corporate purposes. The relation between defendant and the insider implied that the information was to remain confidential. The insider did not expect the defendant to use the information for his personal gain or make the information public. The insider did not breach his fiduciary duty to shareholders because his disclosure of inside information to the defendant was within his authority as an officer of the corporation. Since the insider did not breach his fiduciary duty, defendant could not be liable under § 10(b) as a tippee. The court held that the defendant became a "temporary insider," thus assuming the duties of an insider by virtue of a special relationship with the corporation. The defendant was subjected to liability under § 10(b) for trading on the basis of material nonpublic information received through the special confidential relationship.

A similar issue arose in Moss v. Morgan Stanley Inc., 719 F.2d 26 (2d Cir. 1983). A shareholder who unwittingly sold stock of a target company on the open market prior to public announcement of a tender offer brought an action under § 10(b) and Rule 10b-5 against a person who purchased target shares on the basis of material nonpublic information that he acquired from the tender offeror's investment adviser. Since the defendant had no direct relationship with the target, he was not an insider. Relying on *Dirks*, the court determined that the defendant did not enter into "a special confidential relationship in the conduct of the business of the enterprise." Further, the corporation did not "expect the outsider to keep the disclosed nonpublic information confidential" and the relationship did not "imply such a duty." *Dirks*, 103 S. Ct. at 3261 n.14. Thus, the shareholder was owed no duty and therefore failed to state a claim for damages under § 10(b) or Rule 10b-5.

The Court examined the SEC's analysis of when a tippee inherits the *Cady, Roberts* obligation to shareholders.[145] The SEC embraces the view that one who receives material nonpublic information from an insider becomes subject to the same duty as the insider.[146] When the tippee knowingly transmits the information to someone who will likely trade on the basis thereof, the tippee will have breached the fiduciary duty he inherited from the insider.[147] The SEC concluded that although Dirks' informants might have been able to disclose knowledge of the fraud at Equity Funding in order to expose it, Dirks, standing in their shoes, breached the fiduciary duty he assumed by dealing with them when he passed the information on to the traders.[148] Thus, in the SEC's view, a tippee would inherit the *Cady, Roberts* duty whenever he receives inside information from an insider.[149]

This view, however, is precisely the same view the Supreme Court rejected in *Chiarella*. The Court noted that the SEC's theory of liability in both *Dirks* and *Chiarella* is based on the belief that all traders must enjoy equal information before trading.[150] The Court rejected the SEC's position as conflicting with the principle set forth in *Chiarella* which states that "only some persons, under some circumstances, will be barred from trading while in possession of material nonpublic information."[151] The Court then reaffirmed *Chiarella*, stating that the "duty [to disclose] arises from the relationship between the parties and not merely from one's ability to acquire information because of his position in the market."[152]

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145. *Dirks*, 103 S. Ct. at 3261-62.

146. *Id. See* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974) (quoting Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967)) ("If [defendants] were not insiders, they would seem to have been 'tippees' . . . and subject to the same duty as insiders.").

147. *Dirks*, 103 S. Ct. at 3262.

148. *Id.* (citing 21 S.E.C. Docket 1401, 1410 n.42 (1981)).

149. *Dirks*, 103 S. Ct. at 3261-62.

150. The SEC attempted to distinguish *Dirks* from *Chiarella* on the grounds that Dirks' receipt of inside information from Secrist, an insider, carried Secrist's duty with it, while in *Chiarella* there was no direct involvement of an insider, thus Chiarella did not inherit the duty to disclose or abstain. As the Court emphasized in *Chiarella*, "mere possession of nonpublic information does not give rise to a duty to disclose or abstain; only a specific relationship does that. And we do not believe that the mere receipt of information from an insider creates such a special relationship between the tippee and the corporation's shareholders." *Dirks*, 103 S. Ct. at 3262 n.15.

151. *Id.* at 3262.

152. *Id.* at 3263 (quoting *Chiarella*, 445 U.S. at 232-33 n.14). The Court feared that imposing a duty to disclose or abstain each time a person knowingly received material nonpublic information could inhibit the policing function of market analysis, which the SEC recognizes as necessary to protect the integrity of the market. Analysts

While rejecting the notion that recipients of inside information automatically acquire a duty to disclose or abstain, the court acknowledged the need for restrictions on certain tippee trading.[153] Insiders are forbidden by their fiduciary relationship from using undisclosed corporate information to their personal advantage.[154] Further, insiders may not give undisclosed corporate information to an outsider for the improper purpose of exploiting the information for their personal benefit.[155] Similarly, the transactions of those who are knowing participants in the breach of the insider's fiduciary duty are equally forbidden.[156] Thus, the duty of a tippee to disclose or abstain may be viewed as derivative from the insider's duty.[157] This reasoning led the court to conclude that certain tippees must inherit the insider's duty to the shareholder "not because they receive information, but rather because it has been made available to them *improperly*."[158] Under Rule 10b-5, disclosure by an insider is prohibited only where a violation of his *Cady, Roberts* duty would occur.[159] Thus, a tippee

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often meet with corporate insiders and use the information obtained as a basis to estimate the value of the corporation's securities. Often the analyst's perceptions, based on inside information, are made available in market letters or otherwise to his clients. Due to the nature of this information, and the nature of the market, the Court recognized that this information could not be made simultaneously available to all the corporation's shareholders or the general public. *Id.*

153. *Id.*

154. *Id.*

155. *Id. See* 15 U.S.C. § 78(t)(b) (1976) (which makes it unlawful to do indirectly "by means of any other person" any act made unlawful by the federal securities laws).

156. *Dirks*, 103 S. Ct. at 3263; *see* Mosser v. Darrow, 341 U.S. 267, 272 (1951) (reorganization trustee held personally liable for permitting employees to profit from trading in securities of the debtor's subsidiaries even though he made no personal profit); Jackson v. Smith, 254 U.S. 586, 589 (1921) (persons who knowingly join with a receiver in purchasing real estate at a sale made by the trustee of a deed of trust mortgage securing a debt due the receiver are jointly and severally liable to the receivership for all profits realized from the purchase); Jackson v. Ludeling, 88 U.S. 616, 631-32 (1874) (third party could not aid directors of a corporation in obtaining the company's property by successfully defeating a sale for $550,000 in order that they might become the purchasers for $50,000).

157. *Dirks*, 103 S. Ct. at 3264. "The tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty." *Chiarella*, 445 U.S. at 230 n.12. This proposition received further support in the recent case of Moss v. Morgan Stanley, Inc., 719 F.2d 26 (2d Cir. 1983), where the court held that there was no special duty of disclosure on broker-dealers simply by virtue of their status as market professionals. *Id.* at 96,757. Indeed, to impose such a duty " 'could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes as necessary to the preservation of a healthy market.' " *Id.* (citing *Dirks*, 103 S. Ct. at 3263 & n.17).

158. *Dirks*, 103 S. Ct. at 3264.

159. *Id.*

assumes the insider's fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information "only when the insider has breached his duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."[160]

Since Dirks' duty to disclose was derivative from that of Secrist's (the insider), the Court next considered whether Secrist's tip was a breach of his fiduciary duty. In examining Secrist's disclosure of confidential corporate information, the Court chose to focus on the purpose of this disclosure, thereby establishing a new standard for determining whether there has been a breach by an insider. Justice Powell stated the test to be "whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent some breach by the insider, there is no derivative breach."[161]

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160. *Id.* The SEC has recognized that tippee liability should be imposed only where the tippee knows, or has reason to know, that the insider has improperly disclosed inside corporate information. In the case of *In re* Investors Management Co., 44 S.E.C. 633 (1971), the Commission stated that the appropriate test for finding "tippee" liability is "whether the recipient knew or had reason to know that the information was nonpublic and had been obtained improperly by selective revelation or otherwise." *Id.* at 643. Commissioner Smith, concurring in *Investors Management*, expressly read this test to mean that as a prerequisite to holding a tippee liable, it must be shown that he received information in breach of an insider's duty not to disclose it. *Id.* at 648-51 (Smith, Comm'r, concurring). *See* 3 Loss, *supra* note 38, at 1451 (a tippee should only be liable under Rule 10b-5 where he knew or at least should have reasonably inferred, that an insider's tip was a breach of trust). *Accord* Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1973); Brudney, *Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 348 (1979); Fleischer, Mundheim & Murphy, *An Initial Inquiry Into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 818 n.76 (1973). Under certain circumstances, an outsider may become a fiduciary of the shareholders and thus become subject to the same duty to disclose or abstain as an insider. These circumstances include situations where "information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation . . . ." These outsiders then become temporary insiders and thus become fiduciaries of the shareholders. *Dirks*, 103 S. Ct. at 3261 & n.14. Accord SEC v. Lund, [Current] FED. SEC. L. REP. (CCH) ¶ 99,495 (C.D. Cal. Sept. 16, 1983) (corporate executive who has received inside information about another company solely for the corporate purposes of both concerns was a temporary insider with a duty to disclose or abstain from trading based on that information).

161. *Dirks*, 103 S. Ct. at 3265. Similarly, in Walton v. Morgan Stanley & Co., 623 F.2d 796 (2d Cir. 1980), the Second Circuit held that an investment banking firm did not acquire or breach any fiduciary duty to a corporation which was not a client when it traded in the corporation's stock on the basis of confidential earnings reports it acquired from the corporation while investigating it for a client. The investment banking firm had received the information with knowledge that it was confidential inside information. Expecting that the firm would keep the information confidential, the company secured no agreement that the firm would do so. The court

The majority purported to find authority for its test in *Cady, Roberts*, where it was stated that a significant purpose of the securities laws is to eliminate the use of inside information for personal advantage.[162] However, as noted by Justice Blackmun in his dissent,[163] there is little support for the majority's requirement of an improper purpose of personal gain.[164] The language in *Cady, Roberts* does not necessarily imply that making use of information for reasons *other* than personal gain *is* permissible.[165] The SEC argued that by focusing on the insider's subjective purpose in transmitting the information, the parties need only fabricate a legitimate business justification to cover up the fraud being perpetrated on the shareholder.[166] The Court countered the SEC's argument by stating that in determining whether a disclosure deceives, manipulates, or defrauds shareholders, the initial inquiry must be whether there has been a breach of the insider's duty.[167] This inquiry requires courts to analyze objective criteria, i.e., whether the insider receives any personal benefit from the disclosure such as a pecuniary gain or an enhancement of this reputation which will increase future earnings.[168]

The Court recognized that a determination of whether an insider derives personal benefit from a particular disclosure of inside information will present a difficult question of fact for the courts.[169] Nevertheless, the Supreme Court deemed essential its limiting principle that an insider personally benefit from disclosure as a prerequisite to liability under Rule 10b-5. But, as the facts of this case indicate, "[M]arket participants are forced to rely on the reasonableness of the SEC's litigation strategy" unless legal limitations exist.[170] Therefore, since the rule adopted by the SEC would have no limiting principle,[171]

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held that in the absence of any fiduciary relationship or confidentiality agreement, the investment firm did not acquire any duty with respect to the information simply by receiving it legitimately. *Id.* at 799.

162. *Dirks*, 103 S. Ct. at 3265; *see also Cady, Roberts*, 40 S.E.C. at 912 n.15.

163. *See supra* note 62.

164. *Dirks*, 103 S. Ct. at 3270 & n.6 (Blackmun, J., dissenting).

165. *Id.*

166. *Id.* at 3265.

167. *Id.* at 3266.

168. *Id.*

169. *Id.*

170. *Id.* at 3266 n.24.

171. Similarly, the result in the dissent leaves a person such as Dirks with no choice but to refrain from trading. The option of disclosure is an illusion. Justice Blackmun recognized that the SEC has not set forth guidelines defining what an adequate disclosure would be. Public disclosure may be effected by "a public release through the appropriate public media, designed to achieve a broad dissemination to

the Court found it vital to have a guiding principle for those whose daily activities are subject to the SEC's inside-trading rules.[172]

In applying the rules thus stated, the Court found no actionable violation by Dirks.[173] Dirks, a stranger to Equity Funding, had no fiduciary duty to its shareholders. He did nothing to cause either officers or shareholders to repose trust or confidence in him. Dirks' informants clearly did not intend that he keep their information in confidence. Further, Dirks neither misappropriated nor illegally obtained the information regarding Equity Funding. Thus, if the insiders did not breach their *Cady, Roberts* duty to shareholders of Equity Funding by disclosing the nonpublic information to Dirks, there was no duty for him to breach when he passed the information on to investors and the *Wall Street Journal*.[174]

The Court determined that neither Secrist nor any other Equity

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the investing public generally and without favoring any special person or group." *In re* Faberge, Inc., 45 S.E.C. 249, 256 (1973). Therefore, Justice Blackmun suggested that the SEC take measures to correct this problem. *Dirks*, 103 S. Ct. at 3273 (Blackmun, J., dissenting). The SEC asserts that analysts remain free to obtain corporate information from management for purposes of filling in the "interstices in analysis" Brief for Respondent at 42 (quoting *Investors Management Co.*, 44 S.E.C. at 646). While the dissent was content to leave this problem open for future resolution, the majority observed that "this rule is inherently imprecise, and imprecision prevents parties from ordering their actions in accord with legal requirements. Unless the parties have some guidance as to where the line is between permissible and impermissible disclosures and uses, neither corporate insiders nor analysts can be sure when the line is crossed." *Dirks*, 103 S. Ct. at 3263 n.17.

172. *Dirks*, 103 S. Ct. at 3266.

173. Dirks argued that he was not a "tippee" because the information he received constituted unverified allegations of fraud that were denied by the management of Equity Funding and thus were not "material facts" that required disclosure before trading. Dirks further contended that the information transmitted to him was not "inside" information, i.e., intended for a confidential corporate purpose, but was merely evidence of a crime. The Solicitor General was in agreement. *See* Brief for the United States as *Amicus Curiae* at 22. The court declined to decide whether the information constituted "material facts" or whether information pertaining to corporate crime is properly characterized as "inside information." For purposes of this decision, the Court accepted the SEC's finding that Dirks was a tippee of material inside information. *Dirks*, 103 S. Ct. at 3266 n.25.

174. *Dirks*, 103 S. Ct. at 3267. Further, in order for Dirks' actions to constitute a violation of Rule 10b-5, there must have been fraud. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 189, 199 (1976) ("Statutory words 'manipulative,' 'device,' and 'contrivance' . . . [connote] intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."). The Court was able to find no evidence that anyone was defrauded by Secrist's disclosure. Clearly, Secrist intended to convey information regarding the fraud at Equity Funding. Secrist merely used Dirks as a means to effectuate the dissemination of the information. As the Court observed, Secrist derived no personal benefit, directly or indirectly, by virtue of his disclosure. *Dirks*, 103 S. Ct. at 3267 n.27.

Funding employees breached their *Cady, Roberts* duty to the corporation's shareholders by disseminating information regarding the fraud to Dirks.[175] The tippers received no pecuniary or personal benefit in exchange for the inside information, nor did they intend to make a gift of valuable information to Dirks.[176] Rather, the tippers were motivated by the desire to expose a massive fraud being perpetrated at Equity Funding. The Court concluded that since there was no breach of the insider's duty to the shareholders, there was no derivative breach by Dirks. Thus, Dirks had no duty to abstain from the use of the information he had obtained regarding Equity Funding.[177]

Justice Blackmun, in his dissenting opinion, argued that Secrist breached his duty to Equity Funding shareholders by transmitting material nonpublic information to Dirks with the ultimate intent that Dirks would cause his clients to trade on that information.[178] This is essentially the theory which the SEC espoused below, i.e., mere possession of inside information imposes a duty to abstain or disclose and therefore is viewed as a 10b-5 violation.[179] The Court, in the majority opinion, cautioned against perceiving a breach of duty whenever inside information is disclosed to securities traders.[180] In so doing, it followed *Chiarella*'s explicit statement that there is "no general duty to forgo market transactions based on material nonpublic information."[181] Such a duty would "depar[t] radically from the established doctrine that duty arises from a specific relationship between two parties."[182] Furthermore, such a strict application of liability under Rule 10b-5 could have a chilling effect on the investigative efforts of securities analysts.[183]

The majority's reasoning withstands an economic analysis as well. In *Dirks*, the petitioner was presented with three choices. First, he could have refrained from disclosing the allegations to anyone. This would have permitted Equity Funding to continue its fraud, thus allowing the market value for the company's securities to remain artificially high. Second, he could have disclosed the information to the authorities responsible for enforcing the antifraud laws.[184] This option was selected

175. *Dirks*, 103 S. Ct. at 3267.
176. *Id.* at 3267-68.
177. *Id.*
178. *Id.* at 3274 (Blackmun, J., dissenting).
179. *Id. See supra* notes 145-52 and accompanying text.
180. *Dirks*, 103 S. Ct. at 3267 n.27.
181. *Id.* (quoting *Chiarella*, 445 U.S. at 233).
182. *Id.*
183. *See supra* note 152 & *infra* notes 193-96 and accompanying text.
184. The option of disclosure is really no option at all since the SEC's posture

by former employees of Equity Funding but had drawn no response.[185] The final alternative, chosen by Dirks, was to make the allegations of fraud available to holders of large blocks of Equity Funding shares.[186]

This method of gaining public disclosure proved to be effective. "To economists, it is immaterial whether or not the use of the undisclosed information involved a [gain] or loss to the user, or would result in an opportunity for profit."[187] What is important from an economist's perspective is that the rampant unloading of the Equity Funding stock served to alert both the shareholders and the market to the probable truth of the adverse information regarding Equity Funding.[188] "From an economist's point of view, the sellers provided disclosure to the securities market, [causing] the market to price the security much more efficiently."[189] The sale of shares by those companies to whom Dirks relayed the allegations of fraud caused a sharp decline in the market value of Equity Funding stock.[190] The sharp increase in volume and the sharp decrease in market price stimulated rumors in the market.[191] Almost immediately, investigations by regulatory and governmental agencies began. Twelve days after the sales by informed investors began, the New York Stock Exchange halted trading in Equity Funding stock.[192]

The majority's position has the effect of encouraging private

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as to when the duty to disclose attaches is far from clear. *Dirks*, 103 S. Ct. at 3273 (Blackmun, J., dissenting):

> [T]he SEC seemingly has been less than helpful in its view of the nature of disclosure necessary to satisfy the disclose-or-refrain duty. The Commission tells persons with inside information that they cannot trade on that information unless they disclose; it refuses, however, to tell them how to disclose . . . . This seems to be a less than sensible policy which it is incumbent on the Commissioner to correct.

Id.

The majority agrees with the dissent's assessment of the problem, by observing that the SEC's rule is inherently imprecise and therefore prevents the parties involved from ordering their actions in accord with legal requirements. The majority concluded that "unless the parties have some guidance as to where the line is between permissible and impermissible disclosures and uses, neither corporate insiders nor analysts can be sure when the line is crossed." *Id.* at 3263 n.17.

185. *See Dirks*, 681 F.2d at 832 n.6.

186. *Dirks*, 103 S. Ct. at 3258. *See* Heller, Chiarella, *SEC Rule 14e-3 and* Dirks: *"Fairness" versus Economic Theory*, 37 BUS. LAW. 517, 549 (1982) [hereinafter cited as Heller].

187. Heller, *supra* note 186 at 549.

188. *Id.*

189. *Id.*

190. *Dirks*, 681 F.2d at 832.

191. *Id.*

192. *Id.*

analysts to ferret out information which may assist the SEC in monitoring the marketplace. Had the dissent's view prevailed,[193] a chilling effect would have resulted; for few analysts, brokers, or other securities professionals who heard rumors of corporate fraud could be expected to follow a course of action similar to Dirks for fear of the SEC's reprisals. "Investigative efforts are costly, and if private parties who are in the business of ferreting out and analyzing information are not allowed to trade with or even transmit their findings until the information is fully disclosed to the public at large, they will have no reason to undertake their investigation at all."[194] Although analysts have access to public records, few corporate conspiracies can be detected without obtaining information from inside sources. As a consequence, if the dissent's approach were adopted, the role of securities professionals in detecting and analyzing major corporate crimes would cease.[195] But if investors can continue to rely on analysts, even those acting in their own economic interest, to assist the government in monitoring the securities markets, their reliance on the integrity of the marketplace will be strengthened.[196]

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193. *See supra* text accompanying note 180; *supra* notes 145-52 and accompanying text. The dissent seeks to minimize Dirks' role in exposing the fraud at Equity Funding. The SEC itself previously recognized that "it is clear that Dirks played an important role in bringing [Equity Funding's] massive fraud to light, and it is also true that he reported the fraud allegations to [Equity Funding's] auditors and sought to have the information published in the *Wall Street Journal.*" *Dirks*, 103 S. Ct. at 3259-60 n.3 (citing 21 S.E.C. Docket 1401, 1412 (1981)). An anomalous result would ensue if the person responsible for exposing a massive corporate fraud is punished for his efforts. Until the Equity Funding fraud was disclosed, information in the market was grossly inaccurate. If not for Dirks' actions, the fraud might have continued for an indefinite period.

194. Brief for the United States as *Amicus Curiae* at 27.

195. *Id.*

196. *Id.* at 29. *Accord* Scott, *Insider Trading: Rule 10b-5 Disclosure and Corporate Privacy: A Comment*, 9 J. LEGAL. STUD. 813 (1980) (Scott distinguished between the use of inside information and the situation in *Dirks*. Since inside information will eventually be disclosed, or accurately reflected in the corporation's financial statements, the use of inside information does nothing more than allow the users to get a jump on the market, thereby "accomplishing nothing more than some wealth transfers." Dirks, however, was an outsider expending efforts to discover fraud, and fraud detection is a socially valuable activity). Interestingly, Dirks is perceived as both a villain and hero by the lower courts. The SEC, which advocated his censure, still applauded his efforts. *See supra* note 193. Judge Wright, writing for the District of Columbia Circuit Court of Appeals, acknowledged the value of Dirks' efforts while at the same time condemning his actions. "Largely thanks to Dirks one of the most infamous frauds in recent memory was uncovered and exposed," while governmental authorities "repeatedly missed opportunities to investigate Equity Funding." *Dirks*, 681 F.2d at 829.

VI. CONCLUSION

In *Dirks v. SEC*, the Supreme Court has made clear that the existence of a fiduciary relationship between a tipper (insider) and the shareholders of a corporation is a prerequisite to a finding of tippee liability under Rule 10b-5.[197] The Court held that a tippee assumes the insider's fiduciary duty to the shareholders of the corporation not to trade on material nonpublic information only when the insider has breached his duty to the shareholders by disclosing the information to the tippee, and the tippee knows or should know that there has been a breach.[198] Thus, the duty of a tippee to disclose or abstain is a derivative of the insider's duty.[199] An insider breaches his duty if he receives personal benefit from undisclosed inside information.[200]

As a result of the Supreme Court's decision in *Dirks*, market participants now have a guiding principle upon which to base their everyday actions. The *Dirks* decision should encourage private analysts such as Raymond Dirks to actively uncover information which could aid in policing the marketplace without fear of reprisal by the SEC. Thus, in the future, a fraud of the magnitude perpetrated at Equity Funding may be quickly discovered and revealed.

The long-term effects of *Dirks*, however, are uncertain. It is unclear whether the misappropriation theory, set forth by Chief Justice Burger in his dissenting opinion in *Chiarella*, will survive *Dirks*. Must the misappropriator owe a duty to a corporation and its shareholders before liability may be imposed under Rule 10b-5?[201]

Some outsiders, such as lawyers, underwriters, and accountants may become temporary insiders.[202] If a duty may be imposed on temporary insiders, how far does the duty extend? In the case of a law firm, does the duty extend to all members of the firm? What about paralegals, secretaries, or the janitor who may discover material inside information in the trash?

It is suggested by one commentator that the Supreme Court, in *Dirks*, evidenced its hostility towards characterization of tippee trading as fraud under section 10(b) and Rule 10b-5.[203] It is his belief that

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197. 103 S. Ct. at 3261.
198. *Id.* at 3264.
199. *Id.* at 3265.
200. *Id.*
201. *See* Nat'l L.J., Sept. 19, 1983, at 19, col. 1.
202. *See supra* note 144.
203. Nat'l L.J., Sept. 19, 1983, at 22, col. 1.

the likely effect of *Dirks* will be to severely limit the use of section 10(b) and Rule 10b-5 as a means to eliminate tippee trading on inside information.[204] If this view is correct, new legislation is needed to allow the SEC and the courts an effective means with which to combat improper trading on inside information.

The *Dirks* decision may serve as a basis upon which Congress and the SEC may devise a strategy that will both restrict unfair insider trading and protect seemingly well-intentioned parties such as Raymond Dirks, while adhering to the guidelines set forth by the Supreme Court.

Arthur M. Krawitz

204. *Id.*