

The Clarification of Tippee Liability Under Rule 10b-5: *Dirks v. SEC*¹ — With the enactment of the Securities Exchange Act of 1934² (the 1934 Act), Congress created a broad mechanism for regulating the purchase and sale of securities. By authority of section 10(b) of the 1934 Act,³ the Securities and Exchange Commission (SEC) promulgated Rule 10b-5,⁴ one of the primary antifraud provisions of the federal securities laws.⁵ Rule 10b-5 prohibits affirmative misrepresentations and half-truths in connection with the purchase or sale of a security. Compliance with the mandates of Rule 10b-5 is effected by the subjection of persons who violate the rule to both criminal liability in actions brought by the Department of Justice⁶ and civil liability in actions brought by either the SEC or private citizens.⁷

¹ *Dirks v. SEC*, 103 S. Ct. 3255 (1983).

² 15 U.S.C. §§ 78a-78kk (1982). For a detailed discussion of the 1934 Act, see Loomis, *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214 (1959).

³ Section 10(b) provides:

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

(b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1982).

⁴ Rule 10b-5 is codified at 17 C.F.R. § 240.10b-5 (1984) and states:

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

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

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

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

Rule 10b-5 was promulgated by the SEC in May, 1942. L. LOSS, *SECURITIES REGULATION* 1426-27 (2d ed. 1961) [hereinafter cited as L. Loss]. For a discussion of Rule 10b-5, see 3 L. Loss, *supra*, at 1421-74; 6 L. Loss, *supra*, at 3526-3647 (Supp. 1969); A. BROMBERG & L. LOWENFELS, *SECURITIES FRAUD & COMMODITIES FRAUD* (1983) [hereinafter cited as BROMBERG & LOWENFELS].

⁵ See A. Jacobs, *The Impact of Rule 10b-5* (1980); 1 BROMBERG & LOWENFELS, *supra* note 4, at § 2.1.

⁶ Criminal liability for violation of Rule 10b-5 is based on section 32(a) of the 1934 Act which provides that persons willfully violating any provision of the Act may be subject to criminal penalties. 15 U.S.C. § 78ff(a) (1982). Comment, *Civil Liability for Insider Trading Under Rule 10b-5: Should It Depend on Fiduciary Relationships?*, 1982 ARIZ. ST. L.J. 965 (1982); *Chiarella v. United States*, 445 U.S. 222, 225 & n.3 (1980). The *Chiarella* Court noted that Chiarella's conviction represented the first instance "in which criminal liability ha[d] been imposed upon a purchaser for section 10(b) nondisclosure. Petitioner was sentenced to a year in prison, suspended except for one month, and a 5-year term of probation." *Id.* at 235 n.20 (citations omitted).

⁷ See, e.g., *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). Both section 10(b) of the 1934 Act and Rule 10b-5 establish that certain conduct is unlawful, yet neither gives a private right of action to a person injured by a violation thereof. Since both the Securities Act of 1933 in sections 11, 12, 13 and 15 and the Securities Exchange Act of 1934 in sections 9, 16 and 18 explicitly provide for civil liability, it is arguable that section 10(b) was never intended to provide for any civil liability. See Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of the Legislative Intent*, 57

Although Rule 10b-5 does not explicitly proscribe nondisclosure of inside information,⁸ the SEC and the courts have created a duty to disclose such information in certain situations in which no affirmative misrepresentation has been made.⁹ Liability for nondisclosure has been founded upon a fiduciary duty inherent in a defendant's status as an insider in the corporation in whose securities he is trading.¹⁰ The focus on the elements of status and fiduciary duty is a result of the fact that the rule has been interpreted with the common law tort actions of fraud and deceit in mind.¹¹ Under common law, nondisclosure of inside information has been prohibited only when there is a duty to speak.¹² Silence, as opposed to a half-truth, has not been actionable at common law unless one party "by concealment or other action intentionally prevents the other from acquiring material information"¹³ or is under a duty to disclose "because of a fiduciary or other similar relation of trust and confidence."¹⁴

One of the most significant developments to result from judicial interpretation of

Nw. U.L. REV. 627 (1963). However, beginning with *Kardon* in 1946 and in every case thereafter which considered the question, a private right of action has been held available for a violation of Rule 10b-5. R. JENNINGS & H. MARSH, *SECURITIES REGULATION* 808 (5th ed. 1982) [hereinafter cited as JENNINGS & MARSH]. The United States Supreme Court in *Superintendent of Insurance of New York v. Bankers Life and Casualty Co.*, 404 U.S. 6, 13 n.9 (1971) recognized the availability of a private damage action under section 10(b) and Rule 10b-5. In Rule 10b-5 private damage actions, the Supreme Court has limited standing to bring such actions to purchasers and sellers of securities. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731-32 (1975) (Court held offerees, who had neither purchased nor sold shares, could not maintain a private cause of action under Rule 10b-5).

⁸ Inside information has been defined as "information intended to be available only for a corporate purpose and not for the personal benefit of anyone." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (*en banc*), cert. denied, 394 U.S. 976 (1969) (quoting *In re Cady, Roberts and Co.*, 40 S.E.C. 907, 912 (1961)).

⁹ See *infra* note 18 and accompanying text. Information which the investor can reasonably be expected to be aware of need not be disclosed. See *Siebert v. Sperry Rand Corp.*, 586 F.2d 949, 952 (2d Cir. 1978).

¹⁰ Officers, directors and majority or controlling shareholders have been held to have the status of "insiders." *Cady, Roberts*, 40 S.E.C. at 912. It has also been suggested that insider status be accorded to independent contractors, such as outside legal counsel and independent certified public accountants who work for the corporation and are privy to corporate information. JENNINGS & MARSH, *supra* note 7, at 914 n.11. Section 16(b) of the 1934 Act defines insiders as directors, officers and 10% beneficial owners. 15 U.S.C. § 78p (1982).

¹¹ It is not uncommon for judges to look to common law concepts since "statutes build on the common law and, especially when statutes are new, judges and lawyers who are trained in the common law are apt to look to it for guidance." 3 L. LOSS, *supra* note 4, at 1430.

¹² RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976) [hereinafter cited as RESTATEMENT]. A plaintiff pursuing a common law action for fraud is required to prove misrepresentation of a material fact, as well as scienter, reliance, causation, privity and damages. *Id.* at § 525. The early common law, based on the tradition of *caveat emptor*, did not prohibit trading on nondisclosed information, provided there had been no affirmative misrepresentation. See generally 1 F. HARPER & F. JAMES, *THE LAW OF TORTS* § 7.14 (1956).

¹³ RESTATEMENT, *supra* note 12, at § 550.

¹⁴ RESTATEMENT, *supra* note 12, at § 551(2)(a). See generally W. PROSSER, *THE LAW OF TORTS* 697 (4th ed. 1971) [hereinafter cited as PROSSER]. The types of confidential or fiduciary relations which supported a duty to disclose were narrowly defined: *Brasher v. First Nat'l Bank*, 232 Ala. 340, 168 So. 42 (1936) (bank and investing depositor); *McDonough v. Williams*, 77 Ark. 261, 92 S.W. 783 (1905) (principal and agent); *Foreman v. Henry*, 87 Okl. 272, 210 P. 1026 (1922) (executor and beneficiary of an estate). The relationship of tenant in common, for instance, did not carry with it, in the absence of fraud, a duty of full disclosure. *Neill v. Shamburg*, 158 Pa. 263, 27 A. 992 (1893). Certain types of contracts, such as those of suretyship and guaranty, insurance and partnership, were deemed to create confidential relations. PROSSER, *supra*, at 697-98.

Rule 10b-5 is the disclose-or-abstain rule.¹⁵ Under this rule, persons in possession of material¹⁶ inside information must either publicly disclose that information before trading or refrain from trading in or recommending the securities involved until the information is disclosed.¹⁷ The duty to disclose-or-abstain was initially limited to corporate officers, directors and controlling shareholders.¹⁸ Subsequently, however, the SEC and the courts broadened the reach of Rule 10b-5 by expanding the category of persons who owe a duty to disclose-or-abstain.¹⁹ In the seminal case of *In re Cady, Roberts & Co.*,²⁰ the SEC held that persons who receive tips from corporate insiders, so-called "tippees," may be held liable for trading on inside information.²¹ Similarly, the United States Court of Appeals for the Second Circuit in *SEC v. Texas Gulf Sulphur Co.*²² and *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*²³ stated that Rule 10b-5 applied to tippees as well as to corporate insiders.²⁴

¹⁵ See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969); see generally Brudney, *Insiders, Outsiders, and Other Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979) [hereinafter cited as Brudney].

¹⁶ The *Texas Gulf Sulphur* court has stated that "The basic test of materiality . . . is whether a reasonable man would attach importance . . . in determining his choice of action in the transaction in question This, of course, encompasses any fact . . . which in reasonable and objective contemplation might affect the value of the corporation's stock or securities" 401 F.2d at 849 (quoting *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (1965)) (emphasis in original).

¹⁷ *Texas Gulf Sulphur*, 401 F.2d at 848-49; Recent Decisions, *Insider Trading — The Extension of the Duty to Disclose Material Inside Information*, 58 NOTRE DAME L. REV. 132, 133 (1982) [hereinafter cited as Recent Decisions, *Insider Trading*].

¹⁸ See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969) (corporate insiders have duty to disclose material inside information or refrain from trading); *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951) (controlling shareholder who purchased shares from minority shareholder has duty to disclose both the appreciated value of inventory not revealed in annual report and the intent to liquidate corporation); *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947) (directors of corporation have duty to disclose to selling shareholders fact that directors had arranged for sale to third corporation for price higher than book value offered to selling shareholders). See *infra* notes 65-81 and 104-11 and accompanying text.

¹⁹ See *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237-38 (2d Cir. 1974), where the Second Circuit imposed Rule 10b-5 liability on institutional investor-tippees who were given information about an impending decline in Douglas Aircraft earnings and sold before the information became public; *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961), where a member of the board of directors of the Curtiss-Wright corporation tipped a broker-dealer regarding a decision by the board to reduce the corporation's dividends. The broker-dealer was found liable by the SEC for selling Curtiss-Wright shares on the basis of the tip; *In re Honohan*, 13 S.E.C. 754, 756 (1943), where the SEC, in a disciplinary proceeding, found a broker-dealer liable as a tippee for submitting bids on the basis of inside information he had derived from a corporate employee of the issuer.

²⁰ 40 S.E.C. 907 (1961). See *infra* notes 83-94 and accompanying text.

²¹ *Id.* at 912.

²² 401 F.2d 833 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969).

²³ 495 F.2d 228 (2d Cir. 1974).

²⁴ The *Texas Gulf Sulphur* court stated, "As Darke's 'tippees' are not defendants in this action, we need not decide whether, if they acted with actual or constructive knowledge that the material information was undisclosed, their conduct is as equally violative of the Rule as the conduct of their insider source, though we note that it certainly could be equally reprehensible." *Texas Gulf Sulphur*, 401 F.2d at 852-53.

In *Shapiro*, the Second Circuit stated that one of the primary purposes of Rule 10b-5 was to deter corporate insiders and their tippees from taking unfair advantage of uninformed investors. *Shapiro*, 495 F.2d at 235. The *Shapiro* court found that the defendant-tippees "knew or should have known of the confidential corporate source of the revised earnings information and . . . knew of its nonpublic nature, [and therefore] were under a duty not to trade in Douglas stock without publicly disclosing such information." *Id.* at 238.

Although the SEC and the Second Circuit stated that tippees could be held liable under Rule 10b-5, the theoretical basis for the extension of liability by the SEC in *Cady, Roberts* was quite different from that relied upon by the Second Circuit. The SEC in *Cady, Roberts* adopted the "fiduciary" theory to define the boundaries of the duty to disclose-or-abstain.²⁵ The fiduciary theory protects the relationship of trust between the insider and the shareholders of the corporation by mandating that when the insider's interest in his own profit or loss conflicts with his duty to protect the shareholders' interests, the latter's interests must prevail.²⁶ Thus, if an insider trades on nonpublic material information without first publicly disclosing such information and profits thereby, he has breached his fiduciary duty.²⁷ To further protect this relationship of trust, the SEC in *Cady, Roberts* extended the duty to disclose-or-abstain to tippees so that insiders could not use intermediaries, such as tippees, as proxies to trade for them and thereby avoid their duty to disclose-or-abstain.²⁸

The Second Circuit, in contrast, adopted the "information" theory to interpret the scope of the Rule 10b-5 duty.²⁹ Under this theory, anyone who possesses material inside information has a duty to either disclose the information or abstain from trading.³⁰ This theory espouses informational parity: all investors in the market should have equal access to all material investment information.³¹

The difference in theoretical approaches taken by the SEC and the Second Circuit is a crucial one because the extent of the duty under Rule 10b-5 depends upon the theory chosen. A court adopting the fiduciary theory would extend the duty to disclose-or-abstain only to traders who are in a relationship of trust with the shareholders of the corporation. Those persons outside the trust relationship could trade on their inside

²⁵ *Cady, Roberts*, 40 S.E.C. at 912.

²⁶ See Recent Decisions, *Insider Trading*, *supra* note 17, at 137. Judge Wright, in *Dirks v. SEC*, 681 F.2d 824 (D.C. Cir. 1982), stated that the fiduciary theory is concerned with the "unfairness and fraud" which results when traders or their informants "profit at the expense or to the exclusion of those who have placed trust in them." *Id.* at 835. Judge Wright went on to state that traditional fiduciary relationships include those "between a corporate director and the corporation's shareholders, or a similar relationship of trust, as between employers and employees or investment bankers and their clients." *Id.*

²⁷ See *Cady, Roberts*, 40 S.E.C. at 916 & n.31. The SEC in *Cady, Roberts* provided the following description of the duties a fiduciary owes to his beneficiary: "[H]e would have a duty not to take a position adverse to them, not to take secret profits at their expense, not to misrepresent facts to them, and in general to place their interest ahead of his own." *Id.* at 916 n.31. The SEC also stated that "[a] significant purpose of the Exchange Act was to eliminate the idea that the use of inside information for personal advantage was a normal emolument of corporate office." *Id.* at 912 n.15.

²⁸ The SEC in *Cady, Roberts* stated that the tipper's position as a director in the corporation "clearly prohibited him from selling the securities affected by the information without disclosure." *Id.* at 912. The SEC went on to state that "[b]y logical sequence, it should prohibit [the tippee]." *Id.* at 1450.

²⁹ *Texas Gulf Sulphur*, 401 F.2d at 848-49.

³⁰ *Id.* at 848.

³¹ *Id.* at 849. Judge Wright, in *Dirks v. SEC*, 681 F.2d 824 (D.C. Cir. 1982), stated that those cases adopting the information theory "imply that the securities laws impose a duty to disclose or refrain from trading based on the nature of the undisclosed information." *Id.* at 835. Judge Wright, however, went on to state that "full equality of access to information is an illusory goal." *Id.* at 835 n.14. See Herman, *Equity Funding, Inside Information, and the Regulators*, 21 UCLA L. Rev. 1, 17-28 (1973) [hereinafter cited as Herman] (discussing practicality of information theory).

information with impunity. In contrast, a court adopting the information theory would impose a duty to disclose-or-abstain upon *any* trader who possesses inside information.³²

The United States Supreme Court in *Chiarella v. United States*³³ settled this theoretical controversy by adopting the fiduciary theory as the basis upon which to interpret the scope of Rule 10b-5.³⁴ Although the issue of tippee liability was not presented to the Supreme Court in *Chiarella*, the Court left open the possibility that a tippee could be viewed as a "participant after the fact" in the insider's breach of his fiduciary duty to the corporate shareholders.³⁵ Not until *Dirks v. SEC*,³⁶ however, was the Supreme Court directly presented with the issue of whether a tippee of material inside information could be held liable for nondisclosure under Rule 10b-5.

Raymond Dirks was a highly respected securities analyst specializing in insurance company securities with the New York broker-dealer firm, Delafield Childs, Inc.³⁷ On March 6, 1973, Dirks was contacted by Ronald Secrist, a former officer of Equity Funding, a corporation primarily engaged in selling life insurance and mutual funds.³⁸ Secrist told Dirks that the assets of Equity Funding had been vastly overstated as a result of fraudulent practices within the corporation,³⁹ and he provided Dirks with the names of present and former Equity Funding officers and employees who could support his allegations.⁴⁰ After informing Dirks that a number of regulatory agencies had failed to take any action

³² As Judge Wright stated in *Dirks v. SEC*, 681 F.2d 824 (D.C. Cir. 1982), the information theory states "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." *Id.* at 835.

³³ 445 U.S. 222 (1980).

³⁴ *Id.* at 230. The *Chiarella* Court stated:

[Section 10(b)] liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction. Application of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information.

Id. See *infra* notes 120-34 and accompanying text.

³⁵ *Id.* at 230 n.12.

³⁶ 103 S. Ct. 3255 (1983).

³⁷ *Dirks v. SEC*, 681 F.2d 824, 829 (D.C. Cir. 1982). Dirks had a reputation for conducting aggressive and independent investigations of the companies on which he reported. Brief for Petitioner at 7, *Dirks v. SEC*, 103 S. Ct. 3255 (1983).

³⁸ *Dirks*, 681 F.2d at 829. Secrist had recently been fired from Bankers National, a New Jersey life insurance company which had been acquired by Equity Funding. *Id.* Both the majority and dissenting opinions in the *Dirks* Supreme Court decision, without discussion, assigned Secrist the status of "insider," even though at the time of his disclosure to Dirks he was a former Equity Funding officer. *Dirks*, 103 S. Ct. at 3267-68, 3269.

³⁹ *Id.* Secrist told Dirks that Equity Funding had been creating false insurance files since 1970. *In re Raymond L. Dirks*, 21 S.E.C. Docket 1401, 1402 (1981). The false policies had been sold to reinsurance companies for an amount equal to 80% of the first year premiums. *Id.* at 1402. Equity Funding management hoped that the false policy sales would increase the value of Equity Funding stock. *Id.* To perpetuate the fraud, Equity Funding had to create medical files and death certificates for nonexistent policyholders. *Id.* at 1402-03.

Secrist also contended that Equity Funding had been selling partnerships in nonexistent real estate, that Equity Funding had had connections with the Mafia, and that Equity Funding's former accountant had become suspicious of Equity Funding and had dropped the account. *Dirks*, 681 F.2d at 829-30. The SEC ultimately determined that none of these latter allegations was true. Brief for Petitioner at 8, *Dirks v. SEC*, 103 S. Ct. 3255 (1983).

⁴⁰ *Dirks*, 21 S.E.C. Docket at 1403.

when informed of these charges by other Equity Funding officers and employees, Secrist urged Dirks to disclose the fraud publicly. Dirks went to Los Angeles, the corporate headquarters of Equity Funding, to talk to corporate management and the Equity Funding officers and employees who Secrist had told him could corroborate his story.⁴¹ While investigating Secrist's charges, Dirks also spoke with members of the investment community in an effort to determine if Secrist's allegations had any substance.⁴² Dirks conveyed the information he obtained from these conversations, including any information which undermined Secrist's allegations, to his institutional clients and to other investors.⁴³ During the period of his investigation, Dirks also urged William Blundell, the *Wall Street Journal's* Los Angeles bureau chief, to write an article on the allegations of fraud at Equity Funding.⁴⁴ Blundell refused to write the story, stating that he feared that publishing such damaging accusations might subject the *Journal* to an action for libel.⁴⁵ After the purchase price of Equity Funding stock fell from \$26 per share to under \$15 per share during the two week period in which Dirks was investigating and spreading word of Secrist's charges, the New York Stock Exchange, on March 27, 1973, halted trading in Equity Funding stock.⁴⁶ The SEC stopped trading in Equity Funding securities on March 28⁴⁷ and filed a complaint against Equity Funding on April 2.⁴⁸ A few days later, Equity Funding filed a petition in bankruptcy.⁴⁹ After conducting an investigation into Dirks' role in the exposure of the fraud at Equity Funding, the SEC charged Dirks and five of his institutional clients in an SEC disciplinary proceeding with violating Rule 10b-5.⁵⁰ An administrative law judge found that Dirks' clients had violated Rule 10b-5 by trading on material inside information without first publicly disclosing such information, and that Dirks had violated Rule 10b-5 by tipping material inside information.⁵¹ The administrative law judge cen-

⁴¹ *Id.* at 1403. Dirks visited the president and executive vice-president of Equity Funding. *Id.* They both denied Secrist's allegations, pointing out that three insurance examiners from three states had found nothing wrong at Equity Funding. *Id.* Dirks also met with two of Secrist's principal collaborators, Patrick Hopper and Frank Majerus. *Dirks*, 681 F.2d at 830. Hopper was a former vice-president in charge of investments for one of Equity Funding's insurance subsidiaries. *Id.* Hopper alleged that fictitious insurance had been discussed openly at Equity Funding, sales figures were highly irregular, and nonexistent assets were on Equity Funding's books. *Dirks*, 21 S.E.C. Docket at 1403. Majerus, a former Equity Funding comptroller, admitted he personally had falsified ledgers in 1970 to hide the fictitious policies being carried on Equity Funding's books. *Id.*

⁴² *Dirks*, 681 F.2d at 831.

⁴³ *Id.* On March 12, Dirks contacted Boston Company Institutional Investors, Inc., a registered investment advisor. *Dirks*, 21 S.E.C. Docket at 1403. On March 15 and 16, Boston Co. sold \$1.2 million worth of Equity Funding securities. *Id.* On March 2, Boston Co. liquidated its clients' remaining holdings of more than \$7.5 million of Equity Funding securities. *Id.* at 1404. Dirks subsequently contacted the Dreyfus Corporation, which sold a recently acquired \$500,000 Equity Funding debenture. *Id.* at 1405. In addition, Dirks contacted Tomlin, Zimmerman & Parmlee, which liquidated all of its clients' Equity Funding holdings of more than \$487,000. *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.* at 1405-06.

⁴⁸ *Dirks*, 681 F.2d at 832. For the full text of the Complaint and Final Judgment of Permanent Injunction and Appointment of Special Investigator and Director, see SEC v. Equity Funding Corp. of Am., [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,917 (C.D. Cal. April 3, 1973).

⁴⁹ *Dirks*, 21 S.E.C. Docket at 1406.

⁵⁰ *Id.* The five institutional clients were the Boston Company Institutional Investors, Inc., The Dreyfus Corporation, John W. Bristol and Co., Tomlin, Zimmerman & Parmlee, Inc. and Manning and Napier. *Id.*

⁵¹ *Id.* at 1412.

sured four of the five trading clients and recommended that Dirks be suspended from associating with a broker or dealer for sixty days.⁵² Dirks and the SEC Enforcement Division appealed the administrative law judge's decision to the SEC.⁵³ The SEC found that Dirks had aided and abetted violations by his clients of section 17(a)⁵⁴ of the Securities Act of 1933 and section 10(b) of the 1934 Act and Rule 10b-5 thereunder.⁵⁵ The SEC, however, reduced the sanction imposed upon Dirks to a censure in order not to "hamper legitimate investigative securities analysis."⁵⁶

Dirks sought review in the United States Court of Appeals for the District of Columbia Circuit.⁵⁷ The District of Columbia Circuit Court affirmed the SEC's order, finding that Dirks had breached his duty of disclosure under Rule 10b-5.⁵⁸ The court explained that its finding that Dirks was liable could be based on either of two theories. First, the court stated that the duty to disclose-or-abstain was based on an ethical standard that applied to broker-dealers, and Dirks had breached that duty by failing to report to the SEC and to the public what he knew.⁵⁹ Second, the court stated that Dirks was a tippee because he had obtained the allegations of fraud from Equity Funding insiders and thus automatically acquired a Rule 10b-5 duty to disclose-or-abstain, a duty which he breached when he repeated the allegations to others who traded.⁶⁰ Dirks subsequently petitioned the Supreme Court for a writ of certiorari, which was granted.⁶¹ In a six-to-three decision, the Supreme Court reversed the District of Columbia Circuit Court's ruling and held that Raymond Dirks was not liable under Rule 10b-5 for failing to disclose material inside information which he had received from insiders of Equity Funding.⁶²

The *Dirks* decision is significant for two reasons. First, the Court clarified the basis upon which tippee liability is founded by firmly rejecting the information theory as the

⁵² *Id.* Dreyfus was the only client not censured. *Id.* at 1402 n.1.

⁵³ *Id.* at 1412. The SEC Enforcement Division sought imposition of a longer suspension against Dirks. Dirks' clients did not appeal their censure. *Id.*

⁵⁴ Section 17(a) provides:

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

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

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

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

15 U.S.C. § 77q(a) (1982).

⁵⁵ *Dirks*, 21 S.E.C. Docket at 1412.

⁵⁶ *Id.* The SEC noted Dirks' role in uncovering the Equity Funding fraud and his unblemished record as an analyst for 20 years. *Id.*

⁵⁷ *Dirks v. SEC*, 681 F.2d 824 (D.C. Cir. 1982).

⁵⁸ *Id.* at 839. When Dirks first petitioned for review in the District of Columbia Circuit Court, a split panel of the court issued a three-paragraph judgment denying the petition for the reasons given by the SEC in its ruling. Brief for Petitioner at 4, *Dirks v. SEC*, 103 S. Ct. 3255 (1983). Dirks filed a Petition for Rehearing and Suggestion for Rehearing En Banc. *Id.* The petition was denied but the court issued an opinion written by Judge Wright. *Id.* Judge Robb concurred in the result; only Judge Tamm dissented. *Id.*

⁵⁹ *Dirks*, 681 F.2d at 840.

⁶⁰ *Id.* at 839.

⁶¹ *Dirks v. SEC*, 103 S. Ct. 371 (1982).

⁶² *Dirks*, 103 S. Ct. at 3268.

theoretical underpinning for determining the scope of tippee liability under Rule 10b-5.⁶³ Second, by adopting the fiduciary theory as the basis of tippee liability under Rule 10b-5, the Court restored the financial incentive necessary to encourage the private investigation of securities fraud.⁶⁴ The first section of this casenote will discuss the historical development of the duty to disclose-or-abstain and the persons upon whom the duty has been imposed. The second section will summarize the majority and dissenting opinions in *Dirks*. The third section will present the Court's reasoning in *Dirks* and will develop the thesis that the *Dirks* case was correctly decided.⁶⁵ Finally, the fourth section will analyze the impact the *Dirks* decision will have on the private investigation of securities fraud. It will be submitted that, by limiting the potential that market analysts will be held liable under Rule 10b-5 for revealing instances of securities fraud, the decision will have the beneficial impact of encouraging the private investigation of securities fraud.

1. HISTORICAL DEVELOPMENT OF THE DUTY TO DISCLOSE-OR-ABSTAIN

The first persons upon whom the courts imposed the Rule 10b-5 duty to disclose material inside information or abstain from trading were corporate officers and directors.⁶⁶ In *Kardon v. National Gypsum Co.*,⁶⁶ corporate officers and directors were held to have violated Rule 10b-5 even though they had made no affirmative misrepresentations or half-truths.⁶⁷ The plaintiffs and defendants in *Kardon* were the sole shareholders in a corporation in which they were also the corporate officers and directors.⁶⁸ Without the plaintiffs' knowledge, the defendants arranged to sell the corporation's plant and equipment to another corporation.⁶⁹ The defendants then purchased all of the stock owned by the plaintiffs without disclosing the planned sale.⁷⁰ In the ensuing litigation, the defendants argued that they could be held accountable as trustees only for proven lost corporate profits.⁷¹ The *Kardon* court rejected the defendants' argument and imposed an affirmative duty on all corporate officers and directors to disclose material information regarding the corporation before trading in its securities. The court based this duty on the fiduciary obligations inherent in the insider status of the defendants.⁷²

The class of persons under a duty to disclose-or-abstain was expanded in *Speed v.*

⁶³ See *infra* notes 145-50 and accompanying text.

⁶⁴ See *infra* notes 213-19 and accompanying text.

⁶⁵ See *Kardon v. National Gypsum Co.*, 73 F. Supp. 798, 802 (E.D. Pa. 1947); Comment, *Rationalizing Liability for Nondisclosure Under 10b-5: Equal Access to Information and United States v. Chiarella*, 1980 WIS. L. REV. 162, 167 (1980).

⁶⁶ 73 F. Supp. 798 (E.D. Pa. 1947). Although the 1934 Act does not provide explicitly for a private cause of action under section 10(b), such a cause of action was initially implied in *Kardon*. *Id.* at 802-03. See *supra* note 7.

⁶⁷ *Id.* at 800.

⁶⁸ *Id.* at 801.

⁶⁹ *Id.* at 802.

⁷⁰ *Id.* at 801.

⁷¹ *Id.* at 801-02.

⁷² *Id.* at 802. The court rejected the necessity of proving lost profits:

It is not necessary that they [prove lost profits]. 'The plaintiffs' case was established when the defendants' duty and its breach were proved. This was done by showing that the defendants were officers and directors of Western and that they disposed of the bulk of their corporate assets to an outsider, for their own benefit, without disclosing the transaction to the plaintiffs

Transamerica.⁷³ In *Speed*, the court held that majority shareholders are prohibited from trading on inside information because they are in a fiduciary relationship with the minority shareholders. The court stated that the duty to disclose-or-abstain applied whether or not the majority shareholders were also corporate directors or officers.⁷⁴ In *Speed*, the majority stockholder made a written offer to the minority stockholders to purchase their stock.⁷⁵ After accepting the offer, the minority stockholders brought a class action suit against the majority shareholder. The suit alleged that the majority shareholder had breached his fiduciary duty by releasing an annual report and letter which failed to disclose material information regarding a significant increase in the value of the corporation and the defendant's intention to liquidate the corporation in the near future.⁷⁶ The court found that the defendant's failure to disclose this information was a violation of Rule 10b-5.⁷⁷ In reaching its decision, the court relied principally on the defendant's status as a majority stockholder,⁷⁸ a position which the court equated to that of an officer or director.⁷⁹ According to the court, insider liability under Rule 10b-5 is based upon a relationship of trust and confidence between the shareholders of the corporation and those insiders, whatever their positions, who have obtained confidential information because of their position within the corporation.⁸⁰ This relationship, in the court's view, gives rise to an affirmative duty to disclose-or-abstain because of the "necessity of preventing a corporate insider from (taking) . . . unfair advantage of the uninformed minority stockholders."⁸¹

The *Kardon* and *Speed* courts interpreted Rule 10b-5 as imposing a duty upon corporate directors, officers and controlling shareholders to disclose material information before trading, based on their fiduciary status. In subsequent cases, both the SEC and the courts expanded the category of persons subject to the duty to disclose-or-abstain under Rule 10b-5.⁸² For example, in *In re Cady, Roberts & Co.*,⁸³ a stockbroker, while serving as a director of a corporation, learned that the corporation planned to reduce its dividend.⁸⁴

⁷³ 99 F. Supp. 808 (D. Del. 1951).

⁷⁴ *Id.* at 833, 843.

⁷⁵ *Id.* at 812.

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ The court emphasized the importance of the defendant's status in imposing the duty to disclose: "One of the primary purposes of the Securities Exchange Act of 1934 . . . was to outlaw the use of inside information by corporate officers and principal stockholders for their own financial advantage to the detriment of uninformed public security holders." *Id.* at 829 (citation omitted).

⁷⁹ *Id.* The court stated:

[Rule 10b-5] is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers.

Id. at 828-29.

⁸⁰ *Id.*

⁸¹ *Id.* at 829 (parentheses supplied by the court).

⁸² See *Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974) (tippees), see *infra* notes 112-19 and accompanying text; *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 852-53 (2d Cir. 1968) (*en banc*), cert. denied, 394 U.S. 976 (1969) (court indicated in dictum that tippees could be held liable under Rule 10b-5), see *infra* notes 104-11 and accompanying text; *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961) (persons in special relationship with company subject to Rule 10b-5, even though not insiders), see *infra* notes 83-94 and accompanying text.

⁸³ 40 S.E.C. 907 (1961).

⁸⁴ *Id.* at 909.

The director disclosed this information to one of the partners in his broker-dealer firm, who then sold some of the firm's stock in the corporation without disclosing the inside information to the purchasers.⁸⁵ In holding that the partner's sales violated Rule 10b-5,⁸⁶ the SEC extended liability under Rule 10b-5 to include "tippees," those who receive tips from corporate insiders.⁸⁷ According to the SEC, this extension was necessary to prevent corporate insiders from evading Rule 10b-5 liability by giving material inside information to outsiders.⁸⁸

The SEC began its opinion by stating that although the duty to disclose-or-abstain had been placed principally upon corporate insiders, this group was not the exclusive class of persons upon whom such a duty rested.⁸⁹ Two elements that must be present to establish a Rule 10b-5 violation were articulated by the SEC. According to the SEC, the first element is the existence of a relationship affording access to inside information intended to be available only for a corporate purpose. The second element is a determination that allowing the corporate insider to take advantage of the inside information by trading without disclosure would be unfair to the person who purchases from, or sells to, the corporate insider.⁹⁰ In considering the matter before it, the SEC explained that it was primarily concerned with determining whether the defendant-tippee was in a special relationship with the corporation that provided him with access to information not otherwise available.⁹¹ The SEC found that because the insider-broker's relationship to the company as a director prohibited him from selling the securities without disclosure, by "logical sequence" the defendant-tippee should also be prohibited from profiting without disclosure.⁹²

The SEC imposed liability on the defendant-tippee not because of the privileged access the defendant had to the material nonpublic information, but rather because of the special relationship which the person who had tipped this information had with the corporation whose securities were traded.⁹³ In *Cady, Roberts*, therefore, the SEC extended the duty to disclose-or-abstain to tippees based upon the fiduciary theory.⁹⁴ To protect the fiduciary relationship between the insider and the shareholders, the SEC extended the disclose-or-abstain duty to persons who receive material nondisclosed information from an insider, because their trading would cause an indirect violation of the trust relationship

⁸⁵ *Id.*

⁸⁶ *Id.* at 912.

⁸⁷ The SEC had recognized tippee liability under Rule 10b-5 in an earlier case, *In re Honohan*, 13 S.E.C. 754 (1943). A broker-dealer was able to underbid other bondholders because of inside information he received from a corporate insider of the issuer. *Id.* at 756. The SEC found him liable under Rule 10b-5 as a tippee of a corporate insider. *Id.* at 758.

⁸⁸ Professor Loss has noted: "Whatever duty of disclosure Rule 10b-5 imposes upon officers, directors and controlling persons could be readily bypassed if the same duty were not held to devolve at least upon members of their immediate families." 3 L. Loss, *supra* note 4, at 1450.

⁸⁹ *Cady, Roberts*, 40 S.E.C. at 912. The SEC acknowledged that three categories, directors, officers and controlling shareholders, had previously been held liable, but now stated that these categories "do not exhaust the classes of persons upon whom there is such an obligation." *Id.*

⁹⁰ *Id.*

⁹¹ *Id.* "Thus our task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited." *Id.*

⁹² *Id.* at 916.

⁹³ *Id.*

⁹⁴ Under this theory, when an insider's interest in personal gain conflicts with his fiduciary duty to protect the stockholders' interests, the stockholders' interests must prevail. *Id.* at 916.

between the corporate insider and the stockholders. The SEC concluded that corporate insiders should not be able to do indirectly what they are prevented from doing directly as individuals.

Subsequently, in *In re Investors Management Co., Inc.*,⁹⁵ the SEC expanded the category of persons subject to the disclose-or-abstain duty by adopting a theory which imposed even broader liability on tippees. In *Investors Management Co.*, the SEC held the defendant-tippees liable not because of the existence of a special relationship with the corporation, as it had in *Cady, Roberts*, but rather on the basis of the mere receipt of nonpublic information.⁹⁶ Several of the defendants had received nonpublic information regarding a drop in per-share earnings and projected earnings from a prospective managing underwriter of a public offering of Douglas Aircraft securities.⁹⁷ Subsequently, the defendants sold their Douglas stock without revealing the nonpublic information they had received.⁹⁸ The SEC held that whenever individuals receive information which they know emanates from a corporate source and which places them in a position superior to that of other investors, they have a duty to disclose that information or abstain from trading under Rule 10b-5.⁹⁹

Although the SEC did not base its imposition of liability in *Investors Management Co.* solely on the defendants' receipt of nonpublic information, requiring also a showing that the information had emanated from a corporate source, the decision indicated that the underlying rationale for imposing a duty to disclose-or-abstain under Rule 10b-5 was shifting from the fiduciary theory which the SEC relied upon in *Cady, Roberts* and toward the adoption of an "information" theory.¹⁰⁰ The information theory is based on the view that an investor who possesses inside information should not benefit at the expense of other investors who do not have access to the same nonpublic information.¹⁰¹ This theory assumes that enhancement of the ability of all investors to have equal access to material investment information was one of the major reasons for the enactment of the federal securities laws.¹⁰² The aim of the information theory, therefore, is to protect investors entering the market from suffering losses because another investor has taken advantage of information not available to the rest of the investing public.¹⁰³

⁹⁵ 44 S.E.C. 633 (1971).

⁹⁶ *Id.* at 635.

⁹⁷ *Id.* at 636.

⁹⁸ *Id.* at 636-37.

⁹⁹ *Id.* at 644. The SEC stated:

Our formulation would clearly attach responsibility in a situation where the recipient knew or had reason to know the information was obtained by industrial espionage, commercial bribery or the like Our test would not attach responsibility with respect to information which is obtained by general observation or analysis.

Id. at 641 n.18.

¹⁰⁰ At one point in its decision, the SEC came close to adopting a rule based on possession alone: Considerations of both fairness and effective enforcement demand that the standard as to the requisite knowledge be satisfied by proof that the recipient had reason to know of the non-public character of the information, and that it not be necessary to establish actual knowledge of that fact or, as suggested by respondents, of a breach of fiduciary duty.

Id. at 644.

¹⁰¹ Recent Decisions, *Insider Trading*, *supra* note 17, at 137-38.

¹⁰² See Herman, *supra* note 31, at 17-28.

¹⁰³ See Brudney, *supra* note 15, at 353-67 (arguing that policy underlying section 10(b) and Rule 10b-5 is similar to policy underlying the information theory).

The United States Court of Appeals for the Second Circuit adopted the information theory as the basis of liability under Rule 10b-5 in *SEC v. Texas Gulf Sulphur Co.*¹⁰⁴ In *Texas Gulf Sulphur*, company officials who possessed confidential information regarding a copper strike purchased Texas Gulf Sulphur stock without disclosing the nonpublic information to the sellers.¹⁰⁵ The Second Circuit held that anyone in possession of material inside information is an "insider" and therefore subject to the duty to disclose-or-abstain. The court began its analysis by stating that the policy foundation of Rule 10b-5 is the expectation that all investors have relatively equal access to material information.¹⁰⁶ The court quoted the two elements which the SEC in *Cady, Roberts* had laid down as the basis for imposing liability under Rule 10b-5.¹⁰⁷ In quoting the first element from *Cady, Roberts*, however, the *Texas Gulf Sulphur* court omitted the reference to the requirement of the existence of a fiduciary relationship to find liability. The SEC in *Cady, Roberts* had stated that the first criterion for establishing liability under Rule 10b-5 is "the existence of a relationship giving access" to inside information.¹⁰⁸ The *Texas Gulf Sulphur* court, however, quoted the first element simply as "access" to inside information.¹⁰⁹ According to the *Texas Gulf Sulphur* court, "anyone in possession of material inside information must either disclose it to the investing public, or, . . . must abstain from trading in or recommending the securities concerned while such information remains undisclosed."¹¹⁰ Although the defendants in *Texas Gulf Sulphur* were tippers and not tippees, the court indicated that the broad principles it enunciated could encompass tippees as well.¹¹¹

In the subsequent case of *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,¹¹² the Second Circuit directly addressed the issue of tippee liability under Rule 10b-5.¹¹³ The *Shapiro* court imposed liability on institutional investor-tippees who had been given information about an impending decline in Douglas Aircraft Company earnings and then sold their holdings in Douglas stock before the information became public.¹¹⁴ The information initially had passed properly from Douglas to Merrill Lynch in the course of Merrill Lynch's preparation to underwrite Douglas' debentures.¹¹⁵ Merrill Lynch, however, also passed the inside information to a select group of its institutional clients who then sold their shares of Douglas stock without disclosure.¹¹⁶ The court interpreted Rule 10b-5 as a provision designed to protect the uninformed investing public from being taken advantage of by corporate insiders or their tippees.¹¹⁷ Citing *Texas Gulf Sulphur*, the

¹⁰⁴ 401 F.2d 833 (2d Cir. 1968) (*en banc*), *cert. denied*, 394 U.S. 976 (1969).

¹⁰⁵ *Id.* at 844.

¹⁰⁶ *Id.* at 848. The court stated, "The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions." *Id.* at 851-52.

¹⁰⁷ *Id.* at 848. See *supra* notes 83-94 and accompanying text.

¹⁰⁸ *Cady, Roberts*, 40 S.E.C. at 912.

¹⁰⁹ *Texas Gulf Sulphur*, 401 F.2d at 848.

¹¹⁰ *Id.*

¹¹¹ *Id.* at 852-53. See *supra* note 24.

¹¹² 495 F.2d 228 (2d Cir. 1974).

¹¹³ The defendant-tippees in *Shapiro* were the same parties who were subject to SEC administrative proceedings in *In re Investors Management Co., Inc.*, 44 S.E.C. 633 (1971). See *supra* notes 95-103 and accompanying text.

¹¹⁴ *Shapiro*, 495 F.2d at 232-33.

¹¹⁵ *Id.* at 232.

¹¹⁶ *Id.*

¹¹⁷ *Id.* at 235. The court stated, "The essential purpose of Rule 10b-5 . . . is to prevent corporate insiders and their tippees from taking unfair advantage of the uninformed outsiders." *Id.* (quoting *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876, 890 (2d Cir. 1972)).

Shapiro court stated that anyone in possession of material inside information must disclose it to the public or refrain from trading.¹¹⁸ Even though the tippees in *Shapiro* had no confidential relationship with Douglas, the court found them liable for violating Rule 10b-5.¹¹⁹ Thus, in both *Texas Gulf Sulphur* and *Shapiro*, the Second Circuit rejected the fiduciary theory enunciated by the SEC in *Cady, Roberts* and instead adopted the information theory as the basis of insider and tippee liability under Rule 10b-5.

The United States Supreme Court resolved the conflict between these two theories of liability in *Chiarella v. United States*.¹²⁰ In *Chiarella*, the Court reversed the criminal conviction of an employee of a financial printer who had been convicted of violating Rule 10b-5 for purchasing securities based on knowledge of nonpublic market information which he had acquired in the course of his employment.¹²¹ *Chiarella*, a mark-up person at Pandick Press, handled documents which announced corporate takeover bids.¹²² Until the night of the final printing, the true names of the acquiring and target corporations were concealed by fictitious names or blank spaces.¹²³ *Chiarella*, however, had deduced the true identities before the final printing and had purchased stock in the target companies without disclosing his information publicly.¹²⁴ The Court found the SEC's emphasis in *Cady, Roberts* on the existence of a fiduciary relationship as the basis of the Rule 10b-5 duty to disclose-or-abstain to be fully consistent with the common law of fraud.¹²⁵ Under the common law, the Court noted, the duty to disclose is imposed when one party has information which the other party has a right to know because of a fiduciary or similar relationship of trust and confidence between them.¹²⁶ The protection of the shareholders' trust and confidence in corporate management, the Court concluded, should serve as the basis for imposing the duty to disclose-or-abstain under Rule 10b-5.¹²⁷ In so concluding, the Court rejected the formulation of a duty to disclose-or-abstain founded on the assumption that the federal securities laws created a system of equal access to inside information. Adoption of the information theory as the basis for Rule 10b-5 liability, the Court noted, would mandate recognizing a general duty between all participants in market transactions to forego actions based on inside information.¹²⁸ The Court stated that it was unwilling to recognize such a duty without explicit evidence of Congressional intent.¹²⁹

Applying these principles to the matter before it, the Court held that *Chiarella's* silence was not fraudulent because he was not subject to a duty to disclose-or-abstain.¹³⁰

¹¹⁸ *Shapiro*, 495 F.2d at 236.

¹¹⁹ *Id.* at 238. The court stated, "With respect to the selling defendants (the trading 'tippees'), *Texas Gulf* strongly suggests that the same duty to 'abstain or disclose' should be imposed upon them." *Id.* at 237.

¹²⁰ 445 U.S. 222 (1980).

¹²¹ *Id.* at 224-25.

¹²² *Id.* at 224.

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ *Id.* at 228.

¹²⁶ *Id.* at 227-28.

¹²⁷ *Id.* at 235. The Court 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 welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information." *Id.*

¹²⁸ *Id.* at 233.

¹²⁹ *Id.*

¹³⁰ *Id.* at 232.

The Court stated that no duty could arise under the facts of the case because no fiduciary relationship existed between Chiarella and the target companies' shareholders. Chiarella could not be termed an insider since he had received no confidential inside information from the target companies themselves.¹³¹ He also was not an agent of the selling shareholders or a person in whom they had placed their trust.¹³² In short, the Court could find no basis upon which to hold that a fiduciary relationship existed between Chiarella and the selling shareholders. Absent a fiduciary relationship, the Court was unwilling to impose any liability for trading on the undisclosed information. While the Court in *Chiarella* was not presented with the issue of tippee liability because Chiarella obtained the nonpublic information as a result of his own efforts, it observed in a footnote that tippees of corporate insiders have been held liable under Rule 10b-5 because of their failure to disclose nonpublic inside information before trading.¹³³ The Court stated that the imposition of the Rule 10b-5 duty upon tippees could be viewed as arising from the tippee's role as a "participant after the fact" in the insider's breach of his fiduciary duty.¹³⁴

In *Chiarella*, therefore, the Supreme Court recognized the possibility that tippees who silently trade on material inside information could be held liable under Rule 10b-5. The acceptance by the *Chiarella* Court of the fiduciary theory as the basis for the imposition of the duty to disclose-or-abstain presented a conceptual problem, however, when tippee liability was considered. Unlike the trading insider, the tippee has no pre-existing fiduciary relationship with the shareholders of the affected corporation. After *Chiarella*, the question still remained of how a tippee could acquire the fiduciary relationship necessary to impose liability under Rule 10b-5. This question was presented to the Supreme Court in *Dirks v. SEC*.¹³⁵

II. *DIRKS v. SEC*

A. *The Majority Opinion*

In a six-to-three decision, the Supreme Court reversed the District of Columbia Circuit Court's ruling that Raymond Dirks, as a tippee of corporate insiders, was liable under Rule 10b-5 for failing to disclose material inside information before recommending the sale of Equity Funding securities to others. The majority opinion, written by Justice Powell,¹³⁶ began by outlining the requirements necessary for establishing a violation of section 10(b) and Rule 10b-5 by corporate insiders.¹³⁷ The Court noted that this explication was a necessary first step in defining tippee liability under Rule 10b-5, because tippee liability would be predicated on the insider's duty to disclose-or-abstain.¹³⁸ According to the Court, the insider's act of tipping must first constitute a breach of the insider's fiduciary duty to disclose-or-abstain under Rule 10b-5 before the tippee can inherit such a duty.¹³⁹

¹³¹ *Id.*

¹³² *Id.*

¹³³ *Id.*

¹³⁴ *Id.* at 230 n.12 (citing *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237-38 (2d Cir. 1974)).

¹³⁵ 103 S. Ct. 3255 (1983).

¹³⁶ Justice Powell delivered the opinion of the Court, in which Chief Justice Burger and Justices White, Rehnquist, Stevens and O'Connor joined.

¹³⁷ *Id.* at 3260-61.

¹³⁸ *Id.* at 3264-65.

¹³⁹ *Id.* at 3265.

The Court laid the foundation for establishing the basis of a tippee's duty to disclose-or-abstain by first affirming the principles established in *Chiarella* regarding insider liability under Rule 10b-5.¹⁴⁰ The Court reiterated that the two elements set out by the SEC in *Cady, Roberts*, the existence of a relationship providing access to inside information and the unfairness of allowing a corporate insider to profit from trading without disclosure, were necessary for imposing a duty to disclose inside information under Rule 10b-5.¹⁴¹ The *Dirks* Court noted that *Chiarella* made clear that the mere possession of nonpublic market information does not create a duty to disclose under Rule 10b-5. According to the *Dirks* Court, the duty to disclose such information depends upon the existence of a fiduciary relationship between the parties and "not merely on one's ability to acquire information in the market."¹⁴² In addition, the *Dirks* Court stated that the breach of the insider's fiduciary duty must involve market manipulation or deception to be actionable under Rule 10b-5.¹⁴³ This latter requirement, the Court explained, is present in the case of insider trading because of the inherent unfairness involved when an insider takes advantage of information intended solely for corporate purposes. The Court concluded that an insider's duty to disclose under Rule 10b-5 arises "only when he fails to disclose material nonpublic information before trading on it and thus makes 'secret profits.'"¹⁴⁴

The *Dirks* Court explained that its affirmation of *Chiarella*'s rejection of the information theory was supported by both the lack of evidence of Congressional intent for adoption of such a broad theory of liability under Rule 10b-5, and the inhibiting effect such a theory would have on securities analysts' investigative efforts in the future.¹⁴⁵ The Court recognized the important function analysts serve in determining the proper market value of a corporation's securities.¹⁴⁶ The Court stated that analysts enhance market efficiency in pricing through their efforts to "ferret out and analyze information" by interviewing corporate officers and other insiders.¹⁴⁷ According to the Court, the information obtained as a result of such interviews is often the basis for judgments about the value of a corporation's securities, which judgments are communicated to the analysts' clients.¹⁴⁸ The nature of the public markets, the Court continued, is that this information

¹⁴⁰ *Id.* at 3263. See *supra* notes 120-34 and accompanying text.

¹⁴¹ *Id.* at 3260. See *supra* notes 83-94 and accompanying text.

¹⁴² *Id.* at 3261. The Court stated, "Not to require such a fiduciary relationship, we recognized, would 'depar[t] radically from the established doctrine that duty arises from a specific relationship 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 *United States v. Chiarella*, 445 U.S. 222, 233 (1980)).

¹⁴³ *Dirks*, 103 S. Ct. at 3261 (citing *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 472 (1977)).

¹⁴⁴ *Dirks*, 103 S. Ct. at 3261. (quoting *In re Cady, Roberts, & Co.*, 40 S.E.C. 907, 916 n.31 (1961)).

¹⁴⁵ *Dirks*, 103 S. Ct. at 3262-63. The Court noted that Congress had exempted many market professionals from statutory prohibitions under the 1934 Act. *Id.* The Court interpreted such exemptions to be Congressional "recognition that [market professionals] contribute to a fair and orderly marketplace at the same time they exploit the informational advantage that comes from their possession of [nonpublic information]." *Id.* (quoting *United States v. Chiarella*, 445 U.S. 222, 233 n.16 (1980)).

¹⁴⁶ *Dirks*, 103 S. Ct. at 3263. The SEC itself in the lower administrative proceedings had stated in its opinion, "The value to the entire market of [the analyst's] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors." *Dirks*, 21 S.E.C. Docket at 1406.

¹⁴⁷ *Dirks*, 103 S. Ct. at 3263.

¹⁴⁸ *Id.*

is not simultaneously available to all investors, but instead, only becomes apparent through trading that takes place in the corporation's securities.¹⁴⁹ Noting the significant role that Dirks' investigative efforts had played in correcting a serious inaccuracy in the valuation of Equity Funding's securities, the Court reasoned that analysts would be much less likely to conduct such investigative efforts if the Court imposed a general duty to disclose on all individuals in possession of nonpublic information.¹⁵⁰

Though firmly rejecting the information theory, the Court recognized that its reliance on the fiduciary theory as the basis for imposing a duty of disclosure on insiders presented an analytic problem in determining how a tippee acquires the Rule 10b-5 duty to disclose-or-abstain.¹⁵¹ Noting that tippees, unlike insiders, have no pre-existing fiduciary duties to the corporation or its shareholders, the Court made clear, however, that its rejection of the information theory did not mean that tippees were free to trade on inside information under all circumstances.¹⁵² If tippees had this freedom, the Court explained, insiders prohibited personally from profiting from their inside knowledge could profit by proxy by tipping an outsider under a *quid pro quo* arrangement.¹⁵³ Thus, according to the Court, an outsider who knowingly participates in an insider's breach of his fiduciary duty is subject to the duty to disclose-or-abstain.¹⁵⁴ The Court stated that the outsider's, or tippee's, duty to disclose is derived from the insider's duty to disclose.¹⁵⁵ The Court emphasized that a tippee assumes an insider's duty to disclose, not because of his

¹⁴⁹ *Id.*

¹⁵⁰ *Id.* at 3263 n.18.

¹⁵¹ *Id.* at 3261.

¹⁵² *Id.* The Court distinguished the circumstances present in *Dirks* from those present in *Shapiro*, where the tippee had gained access to inside information as a result of a confidential relationship. *Id.* at 3261 n.14.

¹⁵³ *Id.* at 3263-64.

¹⁵⁴ *Id.* See *Mosser v. Darrow*, 341 U.S. 267, 271 (1951) (allowing trustee to profit by proxy "would open up opportunities for devious dealings in the name of others that the trustee could not conduct in his own"). See also *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005 (1971), where the court stated:

Without such a remedy, insiders could easily evade their duty to refrain from trading on the basis of inside information. Either the transactions so traded could be concluded by a relative or an acquaintance of the insider, or implied understandings could arise under which reciprocal tips between insiders in different corporations could be given.

Id. at 1308.

See also *Jackson v. Smith*, 254 U.S. 586, 589 (1921) (all who knowingly participate with trustee in breach of duty toward trustee's beneficiary are jointly and severally liable to beneficiary for all profits); *Jackson v. Ludeling*, 88 U.S. 616, 629, 631 (1874) (outsiders who join corporate insiders in breach of duty are liable to shareholders); RESTATEMENT (SECOND) OF AGENCY §§ 387, 391 (1958) (agent cannot assist another in taking advantage of his principal).

¹⁵⁵ *Dirks*, 103 S. Ct. at 3264. Professor Loss, who first coined the term "tippee," traced tippee liability to the concept in restitution that "[w]here a fiduciary in violation of his duty to the beneficiary communicates confidential information to a third person, the third person, if he had notice of the violation of duty, holds upon a constructive trust for the beneficiary any profit which he makes through the use of such information." 3 L. LOSS, *supra* note 4, at 1451 (quoting RESTATEMENT OF RESTITUTION § 201(2) (1937)).

Other authorities have also supported the principle that tippee liability exists only where there has first been a breach of trust by an insider. See *Ross v. Licht*, 263 F. Supp. 395, 410 (S.D.N.Y. 1973) ("tippees" defined as "persons given information by insiders in breach of trust and subject to the same duty as insiders"); Brudney, *supra* note 15, at 348; Fleischer, Mundheim, and Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 818 and n.76 (1973) [hereinafter cited as Fleischer, Mundheim, and Murphy].

mere possession of inside information, but because he obtained that information improperly through the insider's breach of his fiduciary duty.¹⁵⁶ The majority stated that tipping could be viewed simply as an indirect means of violating the *Cady, Roberts* disclose-or-abstain duty.¹⁵⁷

The final step in the Court's analysis of tippee liability was a determination of the circumstances under which an insider's tip constitutes a breach of the insider's fiduciary duty.¹⁵⁸ The Court stated that not all disclosures of inside information are inconsistent with the duty insiders owe to shareholders.¹⁵⁹ The Court focused on the second element given in *Cady, Roberts*, the unfairness of allowing an insider to use inside information for personal gain, as the basis for determining which corporate disclosures constitute a breach.¹⁶⁰ The Court stated that the proper test is whether the insider personally benefited, either directly or indirectly, from his disclosure of the nonpublic information.¹⁶¹ Under this test, according to the Court, unless the insider derives some personal benefit from his disclosure, there has been no breach by the insider of his fiduciary duty to the stockholders.¹⁶² Without a breach by the insider, the Court explained, there can be no derivative breach by the tippee.¹⁶³ The Court stated that the determination of whether a breach of duty by the insider has occurred will depend on objective criteria, such as whether the insider received a pecuniary gain or a reputational benefit that would translate into future earnings.¹⁶⁴ Consequently, whether an insider personally benefits from a particular disclosure will be a question of fact which the courts will have to determine from the objective facts and circumstances of each case.¹⁶⁵

Applying these principles to the facts before it, the Court held that Raymond Dirks' actions had not violated Rule 10b-5.¹⁶⁶ Rule 10b-5 liability could not be imposed on Dirks based on a pre-existing fiduciary relationship he had had with Equity Funding's shareholders since, as the Court explained, neither Secrist nor the Equity Funding insiders who had corroborated his allegations had disclosed the information to Dirks with the expectation that Dirks would keep it confidential.¹⁶⁷ In addition, suggesting possibly another basis

¹⁵⁶ *Dirks*, 103 S. Ct. at 3264.

¹⁵⁷ *Id.*

¹⁵⁸ *Id.* at 3265.

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ The Court provided the following as examples of personal benefits: pecuniary gain, enhanced reputation which would translate into future earnings, gifts of inside information to friends or relatives, or, in general, any *quid pro quo* transaction. *Id.* at 3266.

¹⁶² *Id.* at 3265. The Court cited, as an example of a case in which disclosure by an insider did not impose any fiduciary duties upon the tippee, *Walton v. Morgan Stanley and Co.*, 623 F.2d 796 (2d Cir. 1980). In *Walton*, the Second Circuit held that an investment banking firm did not acquire a fiduciary duty to a target 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 as a takeover possibility for a client. *Id.* at 798-99. The *Walton* court found that the investment banking firm had received the information legitimately, and, though it had been expected to keep such information confidential, the corporation had not secured an agreement that the firm would do so. *Id.* The court held that in the absence of any confidentiality agreement, or other fiduciary relationship, the investment bankers did not acquire any duty with respect to this information simply by receiving it legitimately. *Id.* at 799.

¹⁶³ *Dirks*, 103 S. Ct. at 3266.

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

¹⁶⁶ *Id.* at 3267.

¹⁶⁷ *Id.* Though the Court did not cite *Shapiro*, the Second Circuit in *Shapiro* stated that since the

for imposing Rule 10b-5 liability, the Court noted that Dirks had not misappropriated or illegally obtained the information from Equity Funding.¹⁶⁸ Finally, the Court found that Dirks had not become derivatively liable under Rule 10b-5 since neither Secrist nor the other Equity Funding insiders had received a personal benefit by disclosing news of the Equity Funding fraud to Dirks, or had intended to make a gift of such information to Dirks.¹⁶⁹ The Court concluded that the sole purpose of Secrist's and the other insiders' disclosures was to expose the fraud.¹⁷⁰ Since they had not breached the fiduciary duty they owed to the Equity Funding shareholders, the Court stated that there could be no derivative breach by their recipient, Dirks.¹⁷¹ The Court held, therefore, that because Dirks was not "a participant after the fact" in a breach of fiduciary duty by Secrist or the other Equity Funding insiders, he had no duty to disclose-or-abstain under Rule 10b-5.¹⁷²

B. The Dissenting Opinion

Justice Blackmun, joined by Justices Brennan and Marshall, dissented in *Dirks v. SEC*.¹⁷³ The dissent disagreed with the majority's opinion that an insider, in disseminating nonpublic material information, must be motivated by personal gain for his action to constitute a breach of his fiduciary duty.¹⁷⁴ Instead, the dissent interpreted the relationship of trust and confidence between an insider and the corporation's shareholders, which was recognized in *Chiarella* as the basis of the Rule 10b-5 duty,¹⁷⁵ as imposing on an insider the broad duty to take no action which would unfairly harm the corporation's shareholders.¹⁷⁶ Under the dissent's interpretation, an insider's motive for tipping inside information is immaterial because the focus of the disclose-or-abstain duty is the prevention of harm to shareholders as a result of unequal access to nonpublic inside information.¹⁷⁷ Whether an insider profited or intended to profit from the disclosure would not be a factor, in the dissent's view, in determining whether he breached his fiduciary duty.¹⁷⁸

defendant-tippees knew or should have known of the confidential nature of the earnings information on which they traded, they were under a duty not to trade in the affected stock without first publicly disclosing the information. *Shapiro*, 495 F.2d at 238.

¹⁶⁸ *Dirks*, 103 S. Ct. at 3267. This conclusion by the Court suggests that misappropriation of confidential information may give rise to a fiduciary duty. In *Chiarella*, the employee of the printer had in effect stolen the information he traded on, but since this issue was not properly presented to the jury, the Court did not address it. *Chiarella*, 445 U.S. at 235-37. In their respective dissenting and concurring opinions in *Chiarella*, however, Chief Justice Burger and Justice Brennan suggested that a fiduciary duty may arise with respect to nonpublic material information when the information is obtained by unlawful means. *Id.* at 239-43 (Burger, C.J., dissenting); *Id.* at 238-39 (Brennan, J., concurring). The Chief Justice stated, and Justice Brennan agreed, that a disclosure obligation should exist "when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means." *Id.* at 240 (Burger, C.J., dissenting).

¹⁶⁹ *Dirks*, 103 S. Ct. at 3267.

¹⁷⁰ *Id.* at 3267-68.

¹⁷¹ *Id.* at 3268.

¹⁷² *Id.*

¹⁷³ *Id.* (Blackmun, J., dissenting).

¹⁷⁴ *Id.* at 3270.

¹⁷⁵ *Id.*

¹⁷⁶ *Id.* at 3270. The dissent cited the second element of *Cady, Roberts* in support of its interpretation, stating that the second element addressed the harm against which the duty to disclose-or-abstain was meant to protect, i.e., the unfairness to shareholders when an insider trades without disclosure. *Id.* at 3271 n.8.

¹⁷⁷ *Id.* at 3271.

¹⁷⁸ *Id.* The dissent supported this interpretation by stating that personal gain is referred to only

The dissent found support for its view that personal gain is not an element of an insider's breach of fiduciary duty in the Supreme Court's earlier decision in *Mosser v. Darrow*.¹⁷⁹ In *Mosser*, a reorganization trustee was found personally liable for allowing two key employees to profit from trading in securities of the debtor's subsidiaries even though the trustee had neither personally profited nor disclosed the information for fraudulent purposes.¹⁸⁰ According to the dissent, *Mosser* stands for the proposition that a breach of fiduciary duty occurs whenever a fiduciary acts in a manner which is disadvantageous to the person to whom he owes a duty.¹⁸¹ Applying this principle to the facts in *Dirks*, the dissent found that Secrist breached his duty to the purchasers of Equity Funding shares when he disclosed the information to Dirks knowing that it would be passed on to investors.¹⁸² The dissent reasoned that Secrist tipped Dirks with the intention that Dirks' clients would sell their stock to uninformed purchasers of Equity Funding stock, to whom Secrist, as an insider, owed a duty of disclosure.¹⁸³ The dissent went on to assert that because Dirks knew of the breach by Secrist, Dirks should have been held liable as a "participant after the fact."¹⁸⁴

After finding that the majority had no basis in law for imposing a motivational factor on the test for determining whether an insider has breached his fiduciary duty, the dissent also disagreed with the policy upon which the majority's ruling rested.¹⁸⁵ Although conceding that Dirks had played a significant role in exposing the Equity Funding fraud, the dissent did not agree with the majority that Dirks and his clients should be allowed to profit from such inside information at the expense of the Equity Funding shareholders.¹⁸⁶ The dissent stated that Dirks, as a citizen, had an ethical obligation to disclose the

in the first element in *Cady, Roberts*. According to the dissent, the second element in *Cady, Roberts*, which addresses the injury to the shareholder, is not limited by the personal gain requirement. *Id.* at 3271 n.9.

¹⁷⁹ 341 U.S. 267 (1951).

¹⁸⁰ *Id.* at 268, 275.

¹⁸¹ *Dirks*, 103 S. Ct. at 3272. The dissent noted, however, that the duty of a trustee not to misappropriate the trust's assets differs from the duty owed to shareholders by an insider. *Id.* at 3272 n.12. Trustees, for example, are held to a higher standard of care than scienter, the standard applied in Rule 10b-5 actions. *Id.* (citing 3 A. SCOTT ON TRUSTS § 201, at 1650 (1967)). In addition, trustees are not permitted to trade in the securities of the corporation in trust. *Dirks*, 103 S. Ct. at 3272 n.12.

¹⁸² 103 S. Ct. at 3274.

¹⁸³ *Id.* at 3270. The SEC in *Cady, Roberts* stated that an insider's Rule 10b-5 duty extended to purchasers of the corporation's securities as well as to existing shareholders. 40 S.E.C. at 913-14. The SEC embraced the earlier reasoning of Judge Learned Hand that,

[T]he director or officer assumed a fiduciary relation to the buyer by the very sale; for it would be a sorry distinction to allow him to use the advantage of his position to induce the buyer into the position of a beneficiary although he was forbidden to do so once the buyer had become one.

Id. at 914 n.23 (quoting *Gratz v. Claughton*, 187 F.2d 46, 49 (2d Cir.), *cert denied*, 341 U.S. 920 (1951)).

The Supreme Court in *Chiarella* cited with approval the proposition the SEC drew from the *Gratz* decision that an insider's fiduciary duties extended to purchasers of the corporation's securities. *Chiarella*, 445 U.S. at 227 n.8.

¹⁸⁴ 103 S. Ct. at 3270.

¹⁸⁵ *Id.* at 3272-73. The majority had observed that Secrist and Dirks had prevented the fraud from continuing and thus, although some shareholders had been hurt, many more potential investors had been saved from similar harm. *Id.* at 3267-68 n.27.

¹⁸⁶ *Id.* at 3273.

information to the SEC.¹⁸⁷ The dissent viewed the majority's opinion as rewarding, rather than punishing, Dirks for his personal use of the inside information.¹⁸⁸ Although the dissent recognized that the SEC had failed to provide clear guidelines for determining the precise nature of the disclosure necessary to satisfy the disclose-or-abstain duty,¹⁸⁹ the dissent did not agree with the majority's decision to remedy the SEC's deficiencies by limiting the scope of the insider's fiduciary duty to shareholders.¹⁹⁰ In the dissent's view, Secrist violated his fiduciary duty to the corporation's shareholders when he transmitted the information to Dirks, knowing that Dirks would advise his clients to trade on the information. The dissent concluded that Dirks was under a duty to either make this information public or refrain from recommending the sale of Equity Funding shares to others, and therefore he violated Rule 10b-5 when he caused his clients to sell their Equity Funding securities.

III. INTERPRETING THE *DIRKS* OPINION

In *Dirks*, the Supreme Court held that a tippee's liability under Rule 10b-5 is based upon the tippee's participation after the fact in an insider's breach of his fiduciary duty.¹⁹¹ Specifically, the Court stated that an insider breaches his fiduciary duty under Rule 10b-5 when he discloses nonpublic material information for the improper purpose of personal gain.¹⁹² Under the majority's holding, unless the insider personally profits by his disclosure, he has not breached his fiduciary duty to the stockholders, and the tippee cannot inherit a derivative duty to disclose-or-abstain. In contrast, the dissent in *Dirks* maintained that an insider breaches his fiduciary duty whenever his disclosure of inside information results in harm to the shareholders.¹⁹³ The dissent focused on the consequences of the insider's action rather than his motivation for disclosing the information. Despite this disagreement, both the majority and the dissent tied the imposition of the Rule 10b-5 duty to disclose-or-abstain on tippees to a breach by an insider of his fiduciary duty to the shareholders.¹⁹⁴ The major difference between the opinions lies in the interpretation each gives to what constitutes a breach of duty by an insider.

The majority stated that the test for determining if an insider has breached his duty to the stockholders is ascertaining whether the insider has personally benefited, directly or indirectly, from his disclosure.¹⁹⁵ In determining whether a fraudulent purpose was the motivation for the insider's disclosure, the Court stressed that objective criteria would be used.¹⁹⁶ The Court provided guidance to the trial courts in making this determination by suggesting several circumstances which would clearly lead to a determination of a breach of duty by an insider. Factors which the Court indicated would constitute a breach of duty were the receipt by the insider of a pecuniary gain or reputational benefit as a result of the disclosure, the existence of a relationship between the insider and the tippee

¹⁸⁷ *Id.*

¹⁸⁸ *Id.*

¹⁸⁹ The SEC has stated that proper disclosure requires public release through public media designed to reach the investing public. See *In re Faberge, Inc.*, 45 S.E.C. 249, 256 (1973).

¹⁹⁰ *Dirks*, 103 S. Ct. at 3273-74.

¹⁹¹ *Id.* at 3268.

¹⁹² *Id.* at 3265.

¹⁹³ *Id.* at 3271.

¹⁹⁴ *Id.* at 3264, 3270.

¹⁹⁵ *Id.* at 3265. See *supra* notes 158-65 and accompanying text.

¹⁹⁶ *Id.* at 3266.

suggesting a *quid pro quo* or the intention by the insider to confer a benefit, such as a gift of confidential information, on a particular tippee.¹⁹⁷ The majority found support for its decision to condition the determination of whether the insider has breached his fiduciary duty on a showing that the purpose of the disclosure was fraudulent in the SEC's decision in *Cady, Roberts*.¹⁹⁸ In *Cady, Roberts*, the SEC stated that a significant purpose of the 1934 Act was to dispel the idea that the use of nonpublic inside information for personal advantage was a fringe benefit of corporate office.¹⁹⁹ This statement demonstrated, in the majority's view, that the SEC had already set the standard for determining a breach of duty by an insider by identifying the elimination of personal benefit from insider use of corporate information as a major purpose of the federal securities laws.

The dissent disagreed with the majority's insertion of a motivational requirement into the fiduciary duty doctrine under Rule 10b-5. According to the dissent, an insider breaches his duty to the shareholders whenever his actions harm the shareholders unfairly.²⁰⁰ Because Secrist breached his duty to the shareholders by disclosing inside information to Dirks to the financial injury of some Equity Funding shareholders, the dissent would have found Dirks liable. The dissent analogized Secrist's duty to the corporation's shareholders to a trustee's duty to the corporation not to mismanage its assets, the situation presented in the Supreme Court's earlier decision in *Mosser v. Darrow*.²⁰¹ In *Mosser*, the dissent pointed out, the trustee was held liable for activities of employees under him who traded on inside information even though the trustee did not personally benefit.²⁰² Although the dissent cited *Mosser* for the proposition that the motive of personal gain is not essential to a trustee's liability, its reliance on the opinion in determining an insider's duty under Rule 10b-5 is somewhat misplaced.²⁰³ The difference between the duties of a trustee and those of an insider is significant enough to substantially weaken the dissent's use of *Mosser* as support for its position that an insider's motivation is irrelevant. For example, trustees are held to a higher standard of care than scienter, the standard to which insiders are held in Rule 10b-5 actions.²⁰⁴ In addition, trustees are prohibited from trading personally in securities of the corporation in trust under any circumstances.²⁰⁵

As the majority in *Dirks* observed, the dissent's focus on shareholder injury in determining whether an insider has breached his fiduciary duty amounted to an adoption of the information theory explicitly rejected by the Court in *Chiarella*.²⁰⁶ As indicated previously, under the information theory, anyone who buys or sells securities based on material inside information which is not generally available to other investors violates Rule 10b-5 because his trading results in financial injury to less informed traders.²⁰⁷ In

¹⁹⁷ *Id.*

¹⁹⁸ *Id.* at 3265.

¹⁹⁹ *Cady, Roberts*, 40 S.E.C. at 912 n.15.

²⁰⁰ *Dirks*, 103 S. Ct. at 3272.

²⁰¹ 341 U.S. 267 (1951).

²⁰² *Dirks*, 103 S. Ct. at 3272.

²⁰³ *Id.* at 3272 n.12.

²⁰⁴ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). The Supreme Court in *Ernst & Ernst* used the term "scienter" to describe a mental state embracing the intent to deceive, manipulate or defraud. *Id.* at 193. The Court made clear that negligence would not constitute scienter. *Id.* at 214.

²⁰⁵ *Dirks*, 103 S. Ct. at 3272 n.12; see *Mosser v. Darrow*, 341 U.S. 267, 271 (1951). See also Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CALIF. L. REV. 1, 2 n.5 (1982).

²⁰⁶ *Dirks*, 103 S. Ct. at 3267 n.27.

²⁰⁷ *Chiarella*, 445 U.S. at 232. See *supra* text accompanying notes 29-31.

both *Chiarella* and *Dirks*, the Court rejected the concept that unfairness due to informational inequality is the basis of Rule 10b-5 liability. Previously, in *Santa Fe Industries v. Green*, the Court had stated that all instances of financial unfairness to shareholders do not violate Rule 10b-5.²⁰⁸ The effect of the dissent's construction of an insider's breach as disclosure resulting in harm to the shareholders is to adopt indirectly the information theory expressly rejected by these earlier decisions. Moreover, in virtually all cases, an insider's disclosure of nonpublic material information to a tippee will result in some harm to the shareholders if the tippee trades on that information without disclosure or tips to other traders who do the same. This proposition is true because, by definition, "material" information is information which would have a significant impact on a reasonable investor's assessment of a security's risk and worth.²⁰⁹ Most investors, therefore, would require some adjustment to the price of the securities being traded if they were aware of the insider's information. The dissent argued that a tippee's mere possession of inside information received from an insider automatically imposes on the tippee the Rule 10b-5 duty to disclose-or-abstain. In contrast, under the majority opinion, a tippee is bound by the Rule 10b-5 duty only when an insider has first breached his fiduciary duty by disclosing inside material information for the improper purpose of personal gain. Absent this improper purpose, a tippee can trade freely without disclosure.

As a practical matter, the difference between the majority's and dissent's interpretations of what constitutes a breach by an insider when he tips inside information will, in many circumstances, be nonexistent. The objective test employed by the majority in determining when an insider has improperly disclosed inside information is a far-reaching one. Under an objective scrutiny, the number of circumstances under which an insider will be able to argue successfully that he received no direct or indirect pecuniary or reputational benefit will be few. For example, the majority stated that gifts of inside information to friends or relatives or anyone with whom the insider maintained a relationship suggesting a *quid pro quo* from the recipient or an intention to benefit that recipient would be prohibited.²¹⁰ Furthermore, the majority, in an attempt to narrow any potential loophole created by its decision, stated that persons such as underwriters, accountants, lawyers and consultants, who enter into special confidential relationships with a corporation and are given access to inside information solely for corporate purposes, will be treated as tippers rather than tippees for Rule 10b-5 purposes.²¹¹ Under this latter restriction, a corporation's provision of information to an underwriter, for example, for a proper purpose will not protect the underwriter who tips or trades for personal profit from Rule 10b-5 liability. By occupying a close relationship to the corporation, the underwriter acquires a fiduciary duty to the corporation's shareholders. Consequently, in most cases, the insider will be found to have breached his fiduciary duty by improperly disclosing inside information, and tippee liability will be found under both the majority's and the dissent's interpretations.

The difference in result between the interpretations of the two opinions arises under

²⁰⁸ *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 474 (1977) (breach of fiduciary duty by officer, director, or controlling shareholder which does not involve misrepresentation or nondisclosure does not violate Rule 10b-5, even if breach is in connection with purchase or sale of stock).

²⁰⁹ Professor Lorie states: "With respect to the analysis of securities, information is anything that changes the investor's subjective probability distribution with respect to future market prices or returns." Lorie, *Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy: A Comment*, 9 J. LEGAL STUD. 819, 820 (1980) [hereinafter cited as Lorie].

²¹⁰ *Dirks*, 103 S. Ct. at 3266.

²¹¹ *Id.* at 3261 n.14.

a factual situation such as the one found in *Dirks* involving the disclosure of information regarding securities fraud. When consideration is given to the possibility that the Equity Funding fraud could have continued undetected had Secrist not disclosed the information to Dirks, the real import of the interpretive difference can be understood and appreciated.²¹² The SEC's failure to act when contacted by Secrist about the ongoing fraud bears out this conclusion. This failure to act may have been in large part due to the SEC's lack of sufficient investigative staff to pursue information it receives regarding securities fraud. Thus, even if the SEC's decision in *Cady, Roberts* had not provided the legal precedent to support the majority's definition of what constitutes an insider's breach in tipping inside information, public policy grounds alone would have supported allowing insiders to tip information regarding fraud within their corporation to others who would investigate and verify such information. Because society as a whole benefits from such disclosures, the cost incurred by shareholders due to their informational inequality is justified. The next section of the casenote will consider the beneficial impact the *Dirks* decision will have on providing an incentive for securities analysts to investigate tips they receive regarding securities fraud.

IV. THE IMPACT OF *DIRKS* ON FUTURE INVESTIGATIVE EFFORTS BY SECURITIES ANALYSTS

A major concern of the federal securities laws, and especially of section 10(b) and Rule 10b-5 of the 1934 Act, is the prevention of fraud and the resulting loss of investor confidence in the securities market.²¹³ Establishing incentives for securities analysts to investigate securities fraud is an important step in achieving these purposes.²¹⁴ The majority in *Dirks* recognized the significant role analysts play in maintaining the integrity of the market. In addition, the Court recognized the deleterious effect an adoption of the information theory would have on this role.²¹⁵ The majority's decision to affirm *Chiarella's* rejection of the information theory was supported by the policies underlying government regulation of the public securities markets. Adoption by the Court of the information theory, which would impose Rule 10b-5 liability on tippees based on mere possession of inside information received from an insider, would have removed the financial incentive for analysts, such as Dirks, to ferret out information on fraudulently valued securities. Additionally, imposing a broad disclose-or-abstain duty upon tippees would not always result in more information reaching all investors through public disclosure. It is important to remember that an option exists under Rule 10b-5 to either disclose *or* abstain.

²¹² *Id.* at 3263 n.18.

²¹³ See Brudney, *supra* note 15, at 334; Fleischer, Mundheim, and Murphy, *supra* note 155, at 816-17; Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801, 805-09 (1980).

²¹⁴ Fleischer, Mundheim, and Murphy, *supra* note 155, at 816-17. See also Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031, 1054-55 (1977).

²¹⁵ *Dirks*, 103 S. Ct. at 3263. The Court stated:

Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. It is commonplace for analysts to 'ferret out and analyze information,' . . . [a]nd information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities.

Id. (quoting *In re Raymond L. Dirks*, 21 S.E.C. Docket 1401, 1406).

Dirks, for example, would not necessarily have disclosed rather than abstained from recommending to others that they sell their Equity Funding stock had he been subject to the Rule 10b-5 duty. Had he known that the expenses he would incur to investigate the Equity Funding fraud would be made without any opportunity for recoupment for his effort, Dirks might rationally have elected to abstain. The fraud at Equity Funding, therefore, might have continued undetected, causing an even larger number of shareholders to suffer eventual losses.²¹⁶ If analysts are not allowed to reap the fruits of their investigative efforts, they may be unwilling to incur the cost of investigation, thereby allowing securities fraud to continue unabated.

The major argument against allowing tippees to trade on the information they receive is that such a policy would offend basic notions of fair play and undermine investor confidence in the market. A cost-benefit analysis of imposing the Rule 10b-5 duty on tippees who possess material nonpublic information regarding securities fraud, however, does not support the adoption of the information theory. The suggested benefit of imposing a broad disclose-or-abstain duty on all tippees under the information theory is that this standard will reduce, if not eliminate, the trading losses of less experienced investors when trading with better informed, more sophisticated market participants.²¹⁷ Although this parity in access to market information would be a significant benefit, the cost of adopting the information theory as the basis of tippee liability under Rule 10b-5 is great. To ensure that relevant information will continue to be uncovered, analyzed and assimilated into the market, the collectors, especially securities analysts, must be provided with financial incentives. Imposing a disclose-or-abstain duty upon such individuals when, as was the case in *Dirks*, the insider who tipped them did not benefit personally by his disclosure, would result in less information regarding fraud being uncovered. In most instances, analysts would abstain from trading rather than incur investigative costs with no hope of eventual remuneration.²¹⁸ Allowing tippees to profit by nondisclosure before trading or tipping, except in cases in which the insider has breached his fiduciary duty, not only will preserve incentives for analysts to act on tips regarding securities fraud, but also will have the residual benefit of assisting in the eradication of fraud from the securities market.²¹⁹

²¹⁶ The *Dirks* Court recognized the weakness of the information theory in protecting the securities market from fraudulent market values:

[T]he central role . . . analysts in general can play in revealing information that corporations may have reason to withhold from the public, is an important one [U]ntil the Equity Funding fraud was exposed, the information in the trading market was grossly inaccurate. But for *Dirks*' efforts, the fraud might well have gone undetected longer.

Id. at 3263 n.18.

²¹⁷ Barry, *The Economics of Outside Information and Rule 10b-5*, 129 U. PA. L. REV. 1307, 1352 (1981)[hereinafter cited as Barry].

²¹⁸ Barry points out that increased regulation "imposes on society the usual administrative costs associated with government intervention in the economy." Barry, *supra* note 217, at 1353 n.167.

²¹⁹ See H. KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* 292-97 (1979) (where the author expresses the view that the information theory would be impractical on a cost-benefit analysis). Kripke states:

The Commission's [proposal] . . . represents an ideological effort to achieve a total equality among buyers and sellers which is unrealistic in a competitive, profitmaking economy. It is not worth the benefit in terms of the cost, and is severely inhibitive of the Commission's avowed goal of the free flow of information into the market.

Id. at 297.

The importance of preserving an incentive for the production of information has been stressed by a number of legal scholars, particularly Professor Kronman.²²⁰ Kronman states that the greater the probability that the information is of the type that would be deliberately produced rather than casually discovered, the more reason to apply a blanket rule permitting use of the information without disclosure.²²¹ As defined by Kronman, deliberately acquired information is information "whose acquisition entails costs which would not have been incurred but for the likelihood, however great, that the information in question would actually be produced."²²² In contrast, if the costs incurred in acquiring the information would have been incurred in any case, the information is said to have been casually acquired.²²³ An example of casually acquired information would be inside information obtained by the tippee as a result of overhearing a conversation between two corporate officers while dining in the company cafeteria. The cost of acquiring this information is the cost of the lunch, an expense which would have been incurred by the tippee anyway. Deliberately acquired information, on the other hand, would be information which a tippee, such as Dirks, gathered as a result of investigative efforts after receiving the initial tip.

Professor Kronman maintains that when information has been deliberately acquired and its possessor is denied the benefit of profiting from its use, the possessor will have an incentive to reduce or eliminate his production of such information in the future.²²⁴ This incentive to reduce or eliminate future efforts arises, according to Kronman, because one who possesses such deliberately acquired information has incurred costs he would have avoided but for the prospect of benefits which the duty to disclose-or-abstain would deny him. Casually acquired information, on the other hand, involves minimal acquisition costs. Consequently, Kronman points out, the denial of the benefit of profiting from casually acquired information will have little or no effect on the production of such information. In the example of casually acquired information given previously, the tippee will continue to eat lunch in the cafeteria though perhaps expend less energy in the future eavesdropping on other diners' conversations.

Kronman does not ignore the existence of a societal benefit in compelling disclosure of all nonpublic material information.²²⁵ A blanket rule requiring disclosure regardless of the acquisition costs of the information might reduce the number of investors who are harmed by trading with persons who possess inside information. Achieving this societal benefit, however, is not without costs. In the case of deliberately acquired information, Kronman notes, the decline in the production of such information will be great.²²⁶ Thus, information regarding fraudulent activity within a publicly traded corporation which requires investigative costs of some significance to analysts will be sharply curtailed. When information of this nature remains undetected, as happened in the case of Equity Funding, confidence in the integrity of the market will be diminished.

²²⁰ Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1 (1978). See *supra* notes 214, 217 and 219 and *infra* note 229 for citations to other legal scholars who discuss the need for maintaining an incentive for the production of information impacting upon the valuation of securities.

²²¹ *Id.* at 17-18.

²²² *Id.* at 13.

²²³ *Id.*

²²⁴ *Id.* at 13-14.

²²⁵ *Id.* at 14.

²²⁶ *Id.* at 13-14.

Kronman suggests assigning a property right in the information itself to the individual who incurred the costs of its deliberate acquisition.²²⁷ The legal system would establish this property right in the information by permitting the informed party to profit from his information without disclosure to others.²²⁸ By assigning a property right in such information, the legal system would restore to analysts the incentive to incur the costs of its production.

By not imposing a broad duty to disclose-or-abstain upon tippees based merely on the possession of inside information, the *Dirks* Court has encouraged the production of deliberately acquired information, such as information obtained concerning fraudulent activities within a corporation. As the *Dirks* Court held, when an insider has not benefited personally as a result of tipping nonpublic information, the tippee will be allowed to profit from the fruits of his investigative efforts. The tippee will have a property right in the information in that he will be able to exclude others from the use and enjoyment of such information. Not only will analysts, the typical investigators of such information, benefit through the commissions they receive from their clients who trade on such information, but society as a whole will benefit from a securities market in which a fraud, such as occurred within Equity Funding, does not remain undetected.²²⁹

In summary, the *Dirks* Court was correct in affirming *Chiarella's* rejection of the information theory and in limiting the imposition of Rule 10b-5 liability on tippees. The *Dirks* decision furthers the goals of the federal securities laws by encouraging the production and assimilation into the market of relevant information by securities analysts, such as *Dirks*. This investigative activity, in turn, will result in a securities market freer from fraud, which can only increase investors' confidence in the market.

CONCLUSION

Prior to *Chiarella*, there was a theoretical controversy between the SEC and the Second Circuit as to the scope of Rule 10b-5 liability. The SEC adopted the "fiduciary" theory to define the outer limits of the duty to disclose-or-abstain, while the Second Circuit adopted the more expansive "information" theory. The Supreme Court in *Chiarella v. United States* resolved this theoretical conflict by adopting the fiduciary theory as the basis of insider liability under Rule 10b-5. The *Chiarella* Court stated that there is no duty to disclose-or-abstain in the absence of a fiduciary relationship between the insider and the purchasing or selling shareholder. After *Chiarella*, the basis upon which tippees could be found liable under Rule 10b-5 was unclear since tippees often do not stand in a position of trust and confidence with the shareholders of the affected corporation. In *Dirks v. SEC*, the Supreme Court clarified the basis for imposing tippee liability under Rule 10b-5. The Court stated that tippee liability is a derivative form of liability and thus is

²²⁷ *Id.* at 14.

²²⁸ *Id.* at 15.

²²⁹ Professor Lorie states:

The main improvements in the system of disclosure will not come from tinkering with the mandatory system but from encouraging the private quest for information which, though in detail is immaterial, is in its totality of great commercial importance. We should see to it that the Raymond Dirkses of the future get gold medals rather than censure and other punishment.

Lorie, *supra* note 209, at 822.

dependent upon the insider's breach of his fiduciary duty through disclosure of nonpublic inside information for personal gain.

The *Dirks* Court was correct in affirming the *Chiarella* Court's adoption of the fiduciary theory as the basis for imposing the duty to disclose-or-abstain under Rule 10b-5. By rejecting the information theory as the basis of tippee liability, the *Dirks* Court has limited the number of situations in which analysts must disclose-or-abstain and thus recognized that public policy is better served by preserving analysts' incentives to ferret out securities fraud. The effect of adopting the information theory, on the other hand, would have been to encourage fraud by silencing analysts because of their unwillingness to incur investigative costs with no hope of eventual remuneration.

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