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The Tips Are for the Taking: The Supreme Court Limits Third Party Liability in Dirks v. Securities and Exchange Commission

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The Tips Are for the Taking: The Supreme Court Limits Third Party Liability in *Dirks v. Securities and Exchange Commission*

In recent years, a growing furor has developed concerning when the use of material inside information constitutes a violation of Rule 10b-5. SEC enforcement efforts have dramatically increased in an attempt to crack down on use of inside information by "tippers" and "tippees" in violation of Rule 10b-5. In Dirks v. Securities and Exchange Commission, *the United States Supreme Court erected an additional obstacle to the SEC's further enforcement efforts. By judicial fiat, the Court added an element to a Rule 10b-5 violation by engrafting a new personal motivation requirement on the insider's fiduciary duty to his corporation. Under this new rule, neither a "tipper" nor a "tippee" may be held liable for the use of inside information absent a personally motivated gain to the insider. This note undertakes an in-depth analysis of the Court's holding and underlying rationale, concluding both to be without support and contrary to the purpose of Rule 10b-5.*

I. INTRODUCTION

"Rule 10b-5 is plain, concise and unambiguous," according to the Tenth Circuit Court of Appeals.[1] Other courts and some commentators disagree.[2] What is certain under Rule 10b-5 is that the scope of insider trading and "tipper/tippee"[3] liability is not clearly defined. Since the Rule's promulgation, both the Securities and Exchange Commission (SEC) and the United States

1. Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 96 (10th Cir. 1971), *cert. denied,* 404 U.S. 1004 (1971), *cert. denied sub nom.* Reynolds v. Texas Gulf Sulphur Co., 405 U.S. 918 (1972).

2. *See, e.g.,* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) (Rule 10b-5 is "a judicial oak which has grown from little more than a legislative acorn"); Securities and Exch. Comm'n v. National Sec., Inc., 393 U.S. 453, 470 (1969) (Harlan, J., dissenting and concurring) (Rule 10b-5 is "one of the most important and elusive provisions of the securities laws"); 1 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD sections 2.1, 2.3 and 2.4 (1967) [hereinafter cited as BROMBERG] (Rule 10b-5 is one of the broadest rules in coverage of persons and transactions); R. FROME & V. ROSENZWEIG, SALES OF SECURITIES BY CORPORATE INSIDERS 85 (1972) ("it is not always clear which persons are considered insiders for purposes of rule 10b-5"); R. HAMILTON, CASES AND MATERIALS ON CORPORATIONS 780 (2d ed. 1981) (Rule 10b-5 is "broad, flexible, and not hedged with qualifications or limiting doctrine").

3. The quotation marks are used in respect of the wishes of Professor Louis Loss—the person who coined the word "tippee." 6 LOSS, SECURITIES REGULATION 3561 (2d ed. Supp. 1969) [hereinafter cited as LOSS].

Supreme Court have grappled with the wording and purpose of the rule, and its effect on insider trading.[4]

Recently, the Supreme Court decided *Dirks v. Securities and Exchange Commission.*[5] The decision concluded the chronicle of the massive fraud conducted by Equity Funding, first exposed in 1973 with the help of Mr. Dirks. The decision, however, did not answer all of the questions raised by the Equity Funding scandal. Instead, the opinion raised additional questions concerning the scope of Rule 10b-5 as it pertains to insider trading.

The Court held a "tippee" is subject to the "disclose or abstain" rule only where the insider—that is, the "tipper"—has breached his fiduciary duty to the corporation or its shareholders. Accordingly, the "tippee's" liability hinges upon the insider's actions. In so holding, however, the Court engrafted a new "personal motivation" requirement on the fiduciary duty doctrine. An insider—and derivatively, his "tippee"—does not breach his fiduciary duty to the shareholders of a corporation by tipping inside information unless he receives a personal benefit by so doing. The addition of this requirement is unprecedented not only in the field of securities law, but also on the fiduciary duty doctrine itself.

This casenote explores the ramifications of the *Dirks* decision. Initially, the note presents a general overview of insider trading; the topic is canvassed from the enactment of section 10(b) and Rule 10b-5 through the recent pre-*Dirks* judicial decisions. After a brief factual background of the *Dirks* case, the note summarizes the majority and dissenting opinions, and analyzes the Court's decision. Discussed first is the Court's refusal to address whether evidence of a crime constituted inside information. Next, the newly imposed motivational requirement is examined in light of the purposes underlying the securities law and Rule 10b-5. Addressing the merits of the case, the liability of Dirks under both the "fiduciary duty" and the "misappropriation" theories is presented. Finally, the doctrine of "constructive insider" and the impact of the new motivation requirement are contemplated. The note concludes that because of the heavy burden of proof now required of the SEC, insiders who receive hidden personal benefits by tipping will remain unprosecuted.

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4. *See* Chiarella v. United States, 445 U.S. 222 (1980); Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876 (2d Cir. 1972); Securities and Exch. Comm'n v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom.* Coates v. Securities and Exch. Comm'n, 394 U.S. 976 (1969); Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967); *In re* Faberge, Inc., 45 S.E.C. 249 (1973); *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).

5. Dirks v. Securities and Exch. Comm'n, 103 S. Ct. 3255 (1983).

II. HISTORY OF INSIDER TRADING UNDER RULE 10B-5[6]

A. *Origin of Rule 10b-5* [7]

In an effort to curb fraudulent practices in the field of securities, Congress enacted the Securities Exchange Act of 1934 (Exchange Act).[8] One of the purposes of the Exchange Act was "to prevent *inequitable* and *unfair* practices on [the] exchanges and markets. . . ."[9] Included in the Exchange Act was section 10(b),[10] the objective of which is to protect investors by prohibiting fraud in the purchase or sale of any security. A meager supply of information existed, however, as to the legislative intent of section 10(b).[11] To add clarification, the SEC promulgated Rule 10b-5 in 1942.[12]

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6. Liability for insider trading may also be imposed under section 16(b) of the Securities Exchange Act of 1934. 48 Stat. 896 (1934); 15 U.S.C. § 78p(b) (1982). This section covers specified insiders and imposes automatic liability for short-swing profits made within a six month period. *See* 3B H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW section 10.01-.15(1972) [hereinafter cited as BLOOMENTHAL].

7. For in-depth treatment of Rule 10b-5 see 3B BLOOMENTHAL, *supra* note 6, at sections 9.01-.24; BROMBERG, *supra* note 2, *passim;* A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 (2d rev. ed. 1984) [hereinafter cited as JACOBS]; 3 LOSS, *supra* note 3, at 1421-1528.

8. 48 Stat. 881 (1934); 15 U.S.C. §§ 78a-78kk (1982).

9. Preamble to the Securities Exchange Act of 1934, 48 Stat. 881, 881 (1934) (emphasis added).

10. Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982). Section 10 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

11. BROMBERG, *supra* note 2, at sections 2.2(300)-(332); 5 JACOBS, *supra* note 7, section 5.01, at 1-159-60. The section, however, was clearly designed as a " 'catch-all clause to prevent manipulative devices.' " Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202 (1976) (quoting Thomas G. Corcoran, spokesperson for the drafters of the statute).

12. SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1983). Rule 10b-5 provides:

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

Rule 10b-5 prohibits insiders from tipping, recommending, or trading on the basis of inside information.[13] The Rule has also been held to cover many types of fraud in the corporate/securities field. The Rule, however, was issued by the SEC with an eye toward regulating insider trading.[14] Conformably, the policies underlying the rule should be accorded their fullest force and effect in the context of insider trading cases.

Although Rule 10b-5 is supported by a paucity of administrative history, eight policies have been cited as underlying the Rule.[15] Of those eight, two are of great significance. First, the policy of protecting investors has the most legislative and administrative support.[16] This policy is of major import as it indicates Rule 10b-5 was intended to promote investor protection rather than merely

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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.

13. *See* 5A JACOBS, *supra* note 7, section 66.02[a][i], at 3-399. According to Jacobs:

> An insider is a person who (1) possesses inside information, (2) knows or should know the information is nonpublic, and (3) received the information in his business capacity and for a legitimate business reason by virtue of a relationship giving access, directly or indirectly, to the information. . . .
>
> A tippee is a person who (1) possesses inside information, (2) knows or should know the information is nonpublic, (3) received the information other than in his business capacity and for a legitimate business reason, and (4) knows or should know the information "[sic] had been obtained improperly by selective revelation or otherwise. . . .

Id. section 66.02[a][ii], at 3-416. "A tipper is someone who conveys material inside information to a tippee." 5B *id.* section 164, at 7-2 (footnote omitted).

> "Inside information" could be defined as nonpublic facts concerning the business of an issuer, one of its securities, or the market for its securities, and, insofar as the facts relate to the issuer's business, in the usual case are intended to be available only for a corporate purpose and not for the personal benefit of anyone.

5A *id.* section 66.02[b], at 3-453.

14. "[The] SEC . . . emphasized the insider trading aspects of the Rule. . . to make it emphatically clear that the Rule was expected to close . . . loophole[s]." 5 *id.* section 5.02, at 1-163 (quoting Securities and Exch. Comm'n v. Texas Gulf Sulphur Co., 401 F.2d 833, 860 (2d Cir. 1968), *cert. denied sub nom.* Coates v. Securities and Exch. Comm'n, 394 U.S. 976 (1969)).

15. 5 JACOBS, *supra* note 7, at sections 6.01-.09. The policies referred to include: 1) maintaining free securities markets; 2) equalizing access to information; 3) insuring equal bargaining strength; 4) providing for disclosure; 5) protecting investors; 6) assuring fairness; 7) building investor confidence; and 8) deterring violations while compensating victims. These policies are said to reinforce one another. *Id.* section 6.01, at 1-165-66.

16. According to section 10(b), the rule promulgated under it must be "in the public interest or for the protection of investors." Moreover, in promulgating the Rule, the SEC specifically stated the Rule was "necessary . . . for the protection of investors. . . ." Exchange Act Release No. 3230 (May 21, 1942). For a better understanding of the policy of protecting investors see 5 JACOBS, *supra* note 7, section 6.06, at 1-176-80.

police insiders. Many authorities agree that under this policy, Rule 10b-5 applies to sophisticated and unsophisticated investors alike.[17]

The second major policy is one of fairness. Support for this policy lies within the body of the Exchange Act.[18] The policy has its basis in sound equitable principles. In addition, the fairness policy affords courts the flexibility necessary to meet all of the complex practices and difficult ethical problems that can arise under Rule 10b-5.[19] When ruling on insider trading cases, courts should strive to achieve these goals.

B. *Insider Trading: Case Developments*

Before the passage of the Exchange Act, corporate insiders had been held liable for insider trading under three separate theories, including the theory that a fiduciary duty was owed to the corporation and to its stockholders.[20] Then came the passage of section 10(b) and the Exchange Act, and the subsequent promulgation of Rule 10b-5. Initial judicial interpretation of the new Rule held certain insiders to a duty of disclosure.[21]

The first case to extend the duty theory to "tippees" was *In re Cady, Roberts & Co.*[22] A broker-dealer had traded on the basis of

17. *See* 5 JACOBS, *supra* note 7, section 6.06, at 1-178, and authorities cited therein.

18. *See supra* note 9 and accompanying text.

19. 5 JACOBS, *supra* note 7, section 6.07. at 1-185.

20. The majority rule stated that officers and directors owed a fiduciary duty to the corporation and to shareholders dealing with or on behalf of the corporation; as individuals, they owed no fiduciary duty to the shareholders. The minority rule held corporate insiders to a fiduciary duty to the shareholders in all capacities. The third theory was the "special facts" doctrine developed by the Supreme Court in Strong v. Repide, 213 U.S. 419 (1909). This theory stated that an insider might acquire a duty of disclosure where he was privy to special knowledge not known to the purchaser of the stock. 3 LOSS, *supra* note 3, at 1446-48.

21. Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947). The court stated:

> Under any reasonably liberal construction, these provisions [section 10(b) and Rule 10b-5] apply to directors and officers who, in purchasing the stock of the corporation from others, fail to disclose a fact coming to their knowledge by reason of their position, which would materially affect the judgment of the other party to the transaction.

Id. at 800. According to Loss, although *Kardon* was the first judicial pronouncement on Rule 10b-5, the Rule had been mentioned in passing in Baird v. Franklin, 141 F.2d 238, 244 (2d Cir. 1944), *cert. denied,* 323 U.S. 737 (1944). 3 LOSS, *supra* note 3, at 1457.

22. *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961). For discussion concerning *Cady* see Daum & Phillips, *The Implications of* Cady, Roberts, 17 BUS. LAW. 939

inside information received from a director of another company. In holding the broker-dealer liable for a violation of Rule 10b-5, the SEC stated:

> [Officers, directors, and controlling shareholders] do not exhaust the classes of persons upon whom there is such an obligation [to disclose]. Analytically, the obligation rests on two principal elements: first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.[23]

The first element in *Cady* required the showing of a relationship affording access. The second element required the application of the fairness policy to protect investors. Under the facts of the case, the broker-dealer had met these two requirements for establishing a Rule 10b-5 violation and was therefore held liable as a "tippee."

Seven years after *Cady,* the Second Circuit Court of Appeals decided *Securities and Exchange Commission v. Texas Gulf Sulphur Co.*[24] The court restated the *Cady* test but omitted the reference to a relationship.[25] The court held:

> Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.[26]

Thus, the court adopted the "disclose or abstain" rule. Moreover, the court in effect held that mere possession of inside information

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(1962); Comment, *Insider Liability Under Securities Exchange Act Rule 10b-5; The* Cady, Roberts *Doctrine,* 30 U. CHI. L. REV. 121 (1962).

23. *Cady,* 40 S.E.C. at 912.

24. 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom.* Coates v. Securities and Exch. Comm'n, 394 U.S. 976 (1969).

Texas Gulf Sulphur, an important case concerning many areas of Rule 10b-5 coverage, has generated an abundance of discussion. *See, e.g.,* S. GOLDBERG, SEC TRADING RESTRICTIONS AND REPORTING REQUIREMENTS FOR INSIDERS 83-103 (1973); K. PATRICK, PERPETUAL JEOPARDY: THE *Texas Gulf Sulphur* Affair: A Chronicle of Achievement and Misadventure (1972); Bromberg, *Corporate Information:* Texas Gulf Sulphur *and Its Implications,* 22 SW. L.J. 731 (1968); Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the* Texas Gulf Sulphur *Proceedings,* 51 VA. L. REV. 1271 (1965); Ruder, Texas Gulf Sulphur—*The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases,* 63 NW. U.L. REV. 423 (1968); Sandler & Conwill, Texas Gulf Sulphur*; Reform in the Securities Marketplace,* 30 OHIO ST. L.J. 225 (1969); Note, Texas Gulf Sulphur*: Expanding Concepts of Corporate Disclosure Under SEC Rule 10b-5,* 43 ST. JOHN'S L. REV. 425 (1969); Note, Texas Gulf Sulphur*: Its Holdings and Implications,* 22 VAND. L. REV. 359 (1969).

25. The court felt the relationship aspect was not necessary. "Insiders . . . are, of course, . . . precluded from [unfair] dealing, but the Rule is also applicable to one possessing the information who may not be strictly termed an 'insider'. . . ." 401 F.2d at 848.

26. *Id.*

was sufficient to require a person to disclose before or abstain from trading.

The last major insider trading decision prior to *Dirks* was *Chiarella v. United States*.[27] Mr. Chiarella worked for a financial printer, handling documents containing tender offers of unidentified companies. On his own, Chiarella discovered the names of the companies. Thereafter, he traded in those companies' securities to his profit. Chiarella was criminally convicted for this activity.[28] The Supreme Court reversed.[29]

Justice Powell, writing for the Court, restated the *Cady* test, adding back the "relationship" reference omitted by the *Texas Gulf Sulphur* court.[30] Moreover, the Court's ruling pivoted on the relationship concept: "And the duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.' "[31] Pursuing the point, the Court held that a duty to disclose "does not arise from the mere possession of nonpublic market information."[32] The Court, however, mentioned "tippee" liability only in passing dicta.[33]

Chiarella demonstrates that an insider's liability turns on the duty one owes. According to the Court, Mr. Chiarella had no fidu-

27. *Chiarella*, 445 U.S. 222 (1980). For articles concerning *Chiarella* and its effects see Cann, *A Duty to Disclose? An Analysis of* Chiarella v. United States, 85 DICK. L. REV. 249 (1981); Deutsch, Chiarella v. United States: *A Study in Legal Style*, 58 TEX. L. REV. 1291 (1980); Deutsch, *The New Deal and the Burger Court: The Significance of* U.S. v. Chiarella, 57 TEX. L. REV. 965 (1979); Heller, Chiarella, *SEC Rule 14e-3 and* Dirks: *"Fairness" versus Economic Theory*, 37 BUS. LAW. 517 (1982); Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, 70 CALIF. L. REV. 1 (1982); Comment, *Rationalizing Liability for Nondisclosure Under 10b-5: Equal Access to Information and* United States v. Chiarella, 1980 WIS. L. REV. 162; Pitt, Chiarella *Court: Limits on Novel 10b-5 Actions*, Legal Times of Wash., Mar. 31, 1980, at 12.

28. United States v. Chiarella, 450 F. Supp. 95 (S.D.N.Y. 1978).

29. 445 U.S. at 225.

30. *Id.* at 227. The Court stated: "The Commission emphasized that the duty arose from (i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure." *Id.* (footnote omitted) (citing *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 n.15 (1961)).

31. *Id.* at 228 (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1977)).

32. 445 U.S. at 235. Thus, the Court rejected the "possession" test adopted by the *Texas Gulf Sulphur* court. This holding has been interpreted as applying to all material inside information rather than merely nonpublic market information. *See* Langevoort, *supra* note 27, at 42-43.

33. *See infra* note 126.

ciary duty or relationship of trust and confidence with the shareholders.[34] Without that duty, he was not an insider,[35] and could not be liable for his trading and subsequent profits. The stage was then set for the decision in *Dirks*.

III. FACTUAL HISTORY OF *DIRKS*[36]

Raymond Dirks was an investment analyst with Delafield Childs, a New York broker-dealer firm. His speciality was insurance company securities.[37] On March 6, 1973, Ronald Secrist contacted Dirks. Secrist had recently been fired from a vice-president's position at Equity Funding of America. Equity Funding was a diversified corporation primarily engaged in selling life insurance. Secrist alleged that the company was engaged in a massive fraud,[38] and that the SEC had failed to act on similar charges made by other employees.[39] Secrist had told the same story to New York insurance regulators earlier that day.[40]

After a preliminary investigation of certain Equity Funding records which neither confirmed nor disproved the allegations, Dirks had a list drawn up on March 12 of his firm's clients who held Equity Funding securities. He informed two of the clients that same day and began his investigation—throughout which he

34. 445 U.S. at 232-33.

35. "[Chiarella] was, in fact, a complete stranger. . . ." *Id.*

36. The facts and opinion of this case must be distinguished from the recent proceedings against Mr. Dirks.

In June of 1983, Dirks was found to have engaged in a fraudulent scheme in violation of section 17(a) of the Securities Act, section 10(b) of the Exchange Act, and Rule 10b-5. Securities and Exch. Comm'n v. Scott, 565 F. Supp. 1513 (S.D.N.Y. 1983). Dirks has appealed the decision. *See* 15 Sec. Reg. & L. Rep. (BNA) no. 49, at 2264 (1983).

In December, 1983, Dirks was barred by an SEC administrative law judge from any supervisory, managerial, financial, principal, or proprietary association with any broker-dealer. This was the result of a determination by the judge that Dirks had aided and abetted a violation of the SEC's net capital rule and had violated section 14(b) of the SIPA. 16 Sec. Reg. & L. Rep. (BNA) no. 1, at 6-7 (1984).

37. Dirks was Senior Vice-President in charge of the Dirks Brothers Division of Delafield Childs. *In re* Boston Company Institutional Investors, Inc., [1978] Fed. Sec. L. Rep. (CCH) § 81,705 at 80,819 [hereinafter cited as Initial Decision] (initial decision of Administrative Law Judge David Markun).

38. Subsequent to Secrist's initial tip, Dirks spoke with other past and then-present employees of Equity Funding including Patrick Hopper, an officer and major shareholder who had recently left his position at Equity Funding. Hopper and the others partially corroborated Secrist's story. *Id.* at 80,840-44.

39. Dirks v. Securities and Exch. Comm'n, 681 F.2d 824, 829-30 (D.C. Cir. 1982). The two men met the following day and Secrist detailed a list of allegations. Some turned out to be true, others false. When the fraud was finally publicly disclosed, it was discovered that Equity Funding had created false insurance policies, records, sales, and assets. *Id.* at 829-33.

40. *Id.* at 832 n.6.

continued to selectively inform other clients.[41] On March 19 and 20, Dirks contacted the Wall Street Journal which began its own investigation on March 21. On March 23, a reporter for the Journal related the story to the SEC which began an investigation on March 26.[42]

On March 27, the New York Stock Exchange halted Equity Funding trading. The SEC suspended trading in Equity Funding securities the following day. The price of Equity Funding stock had dropped from $26 to $15 during the two-week period of Dirks' investigation. Dirks' clients had rid themselves of close to $15 million worth of Equity Funding stock and debentures during the same period as a result of Dirks' information.[43] Thereafter, the fraudulent practices at Equity Funding became public.

In an administrative hearing, Dirks and five of his clients[44] were found to have violated section 17(a) of the Securities Act of 1933,[45] section 10(b), and Rule 10b-5. Dirks was suspended from association with any broker-dealer for 60 days and all but one of his clients were censured.[46] The SEC subsequently reduced Dirks' sanction to that of a censure.[47]

41. Dirks v. Securities and Exch. Comm'n, 103 S. Ct. 3255, 3269 (1983) (Blackmun, J., dissenting).

42. Dirks v. Securities and Exch. Comm'n, 681 F.2d 824, 831-32 (D.C. Cir. 1982). The Journal published an Equity Funding press release on March 28, but did not publish a story on the scandal itself until April 2, when the SEC filed a complaint against Equity Funding. The Journal reporter who investigated Dirks' information and wrote the subsequent article was later nominated for a Pulitzer Prize for his coverage of the fraud. *Id.* at 832.

43. 103 S. Ct. at 3269 (Blackmun, J., dissenting).

44. Initial Decision, *supra* note 37, at 80,867. The five institutional investors involved were the following: The Boston Company Institutional Investors, Inc.; The Dreyfus Corporation; John W. Bristol & Co., Inc.; Tomlin, Zimmerman & Parmalee, Inc.; and Manning & Napier. *Id.*

45. Securities Act of 1933, 48 Stat. 74, § 17(a), 15 U.S.C. § 77q(a) (1976). 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.

46. Initial Decision, *supra* note 37, at 80,867.

47. *In re* Dirks, 21 S.E.C. Docket 1401 (1981). Dirks was the only party to appeal the Initial Decision. *Id.*

The District of Columbia Circuit Court of Appeals affirmed Dirks' censure based upon the SEC's opinion.[48] Judge Wright issued an opinion stating that an insider's fiduciary duty automatically passes to a "tippee" with the tip, and in the alternative, a "tippee" has a duty to the SEC and to the investing public.[49] One judge concurred in the result, the other judge dissented.[50] The Supreme Court granted Dirks' petition for writ of certiorari.[51]

IV. THE *DIRKS* DECISION

A. *Majority Opinion*

The majority began its opinion with a relatively abbreviated factual history of the case.[52] From the start, the direction in which the Court headed was clear: the facts were narrated with a tendency of bias in favor of Dirks and Secrist[53] and against the SEC.[54] As a result, the gains to Secrist[55] and to Dirks,[56] and the

48. The judgment was unreported. Dirks v. Securities and Exch. Comm'n, No. 81-1243 (D.C. Cir. Mar. 29, 1982) (per curiam) (affirming decision of the SEC).

49. Dirks v. Securities and Exch. Comm'n, 681 F.2d 824 (D.C. Cir. 1982).

50. Neither judge filed an opinion. *Id.* at 828. Thus the lengthy appellate court decision contained the views of only one judge. Undoubtedly, this was an important consideration for the Supreme Court in deciding whether to grant Dirks' petition for writ of certiorari.

51. Dirks v. Securities and Exch. Comm'n, 103 S. Ct. 371 (1982).

52. The factual history of the case was extremely long and complex. For an excellent and detailed account, see Judge Wright's appellate decision. Dirks v. Securities and Exch. Comm'n, 681 F.2d 824, 828-33 (D.C. Cir. 1982).

53. For example, the Court stated: "[T]hroughout his investigation . . . [Dirks] openly discussed the information he had obtained. . ."; Dirks "was in touch regularly" with the Wall Street Journal whom he "urged . . . to write a story;" Dirks "spread word of Secrist's charges" over a "two week period." 103 S. Ct. at 3258. In addition, the Court stated that Dirks played a "central role" through which his "careful investigation brought to light a massive fraud. . . . But for Dirks' efforts, the fraud might well have gone undetected longer." *Id.* at 3263 n.18. These statements indicate the Court felt Dirks' actions were all above board.

54. For example, the Court stated, "As early as 1971, the SEC had received allegations of fraudulent accounting practices at Equity Funding." 103 S. Ct. at 3259 n.3. The Court continued, "Only then [after Dirks' efforts caused the New York Stock Exchange to halt trading] did the Securities and Exchange Commission (SEC) file a complaint against Equity Funding. . . ." *Id.* at 3259 (footnote omitted). These statements indicate the Court felt the SEC was overly lax and inefficient.

55. Secrist's underlying intent was to cause the stock to plummet. *See infra* notes 131-36 and accompanying text. Secrist's personal benefit was the satisfaction of achieving his goal. The majority did not mention Secrist's motivations other than the claimed motive to expose the fraud. 103 S. Ct. at 3258.

56. The majority stated uncertainty existed as to whether Dirks actually received any compensation for his disclosures to his clients. 103 S. Ct. at 3258 n.2. However, the custom of the brokerage industry was succinctly stated in the Initial Decision: Compensation of Dirks' services "was obtained indirectly from securities transactions directed by their clients through the Delafield Childs trading department." Initial Decision, *supra* note 37 at 80,819. Delafield Childs did in fact receive

harm to the Equity Funding shareholders[57] were glossed over where mentioned.

Justice Powell, writing for the majority[58] as he did in *Chiarella,* reaffirmed the holding of *Chiarella*: A duty to disclose or abstain arises from a fiduciary relationship and not from the mere possession of nonpublic market information.[59] The Court then analyzed how a "tippee" could be held liable for a violation of Rule 10b-5. In their analysis, the majority rejected the SEC view that "tippees" who receive material nonpublic inside information assume the duties of the insider.[60] The Court believed the view was too similar to the SEC argument rejected by the *Chiarella* Court. Justice Powell stated the two SEC arguments were based upon the invalid "equal information" theory—the theory that all investors must be apprised of the same information before trading.[61]

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additional business as a result of Dirks' knowledge. Dirks v. Securities and Exch. Comm'n, 681 F.2d 824, 831 (D.C. Cir. 1982).

In addition to the business Dirks gained for Delafield Childs, he gained an enhanced reputation in the brokerage community. Once the fraud was publicly exposed, it was the subject of countless articles. *See, e.g.,* Cole, Phone Call Set Off Equity Funding Scandal, N.Y. Times, April 6, 1973, at 1, col. 4; *see also* the Wall Street Journal series: Herman, How Ronald H. Secrist Sank Equity Funding with Two Phone Calls, Wall Street Journal, May 8, 1973, at 1, col. 4; Meyer, Digging Deeper, Equity Scandal Grows, Involves $120 Million in Nonexistent Assets, April 24, 1973, at 1, col. 6; Elia, Before the Fall, Many Officers Sold Equity Funding Stock Before Scandal Broke, April 20, 1973, at 1, col. 6; Rustin & Meyer, Ear to the Ground, How the Word Spread about Equity Funding; Was it Inside Data? April 9, 1973, at 1, col. 6; Blundell, A Scandal Unfolds, Some Assets Missing, Insurance Called Bogus at Equity Funding, April 2, 1973, at 1, col. 6. The name recognition alone that Dirks received as a result of those articles must have been enormous.

57. The shareholders lost millions of dollars. *See* 103 S. Ct. at 3258.

58. In addition to Justice Powell, the majority included Chief Justice Burger, Justice White, Justice Rehnquist, Justice Stevens, and Justice O'Connor.

59. 103 S. Ct. at 3261.

60. *Id.* at 3262.

61. According to the Court, the SEC in *Chiarella* argued that anyone who receives inside information incurs a duty to disclose or abstain; and the SEC in *Dirks* argued that anyone who receives inside information from an insider incurs a fiduciary duty to disclose or abstain. Each argument merely states the same point: all investors should have equal access to information before trading. 103 S. Ct. at 3261-63.

The Court, however, misread the SEC's argument in *Dirks.* The SEC argued a "tippee" inherits the fiduciary duty of the insider who has passed along inside information. The insider's fiduciary duty is to either disclose or abstain from trading based upon inside information. If the insider tips the inside information without disclosure, he is liable for all subsequent trading without disclosure by the "tippee" (and "tippees" of the "tippee"). If a trade without disclosure occurs, the insider has breached his duty. The "tippee," because he inherited the duty, would also inherit the breach. The "tippee" would thus be liable as well.

The majority rejected the SEC's "inherit a duty" argument. Instead, the major-

According to Justice Powell, this theory would "have an inhibiting influence on the role of market analysts. . . ."[62]

However, "[t]he need for a ban on some tippee trading is clear."[63] Consequently, the Court held that because tipping is an indirect means of violating the "disclose or abstain" rule, a "tippee" assumes an insider's fiduciary duty only when the insider has breached his duty by disclosing the inside information to the "tippee" and the "tippee" knows or should know that a breach exists.[64]

Hence, to determine the liability of the "tippee", the focus is placed on the insider. Did the insider breach his fiduciary duty by tipping inside information?[65] The Court declared the *only* time the fiduciary duty is breached occurs when the insider personally benefits: "[T]he test is whether the insider personally will benefit, directly or indirectly, from his disclosure."[66] If the insider does not breach, then the "tippee" cannot be held liable.[67] The Court drew its support for this new "personal motivation" requirement from a footnote in *Cady* stating that "a purpose of the securities laws was to eliminate 'use of inside information for personal advantage.' "[68]

According to the Court, this requirement of personal motivation is easily proven[69]—courts need simply look to "objective facts and

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ity stated a "tippee" is only liable where the insider breaches. In effect then, the majority held a "tippee" inherits the insider's breach. The result is the same as in the SEC's argument, except the addition of the motivation requirement. *Id.*

62. 103 S. Ct. at 3263.

63. *Id.* At this point, rather than expounding upon why the ban is needed, the majority simply added that the insider must not personally gain. *Id.* The majority seemed to imply "tippee" trading is only wrong where the insider personally benefits.

64. The Court prefaced this holding by stating that "some tippees must assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them *improperly.*" *Id.* at 3264 (emphasis in original).

Clearly, the Court, while claiming to reject the SEC's argument, had actually adopted a modified version. The Court added a qualification so that the duty is inherited only when inside information is made available "improperly." In theory, disclosure should be improper in all instances except when made for a legitimate business reason. Surely, Secrist did not tip for such a reason. *See infra* notes 131-36 and accompanying text regarding Secrist's intentions.

65. 103 S. Ct. at 3265.

66. The Court continued: "Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach." *Id.* (footnote omitted).

67. *Id.*

68. *Id.* (quoting *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 n.15 (1961)). The majority also drew support from a concurring opinion in *In re* Investors Management Co., 44 S.E.C. 633, 648 (1971) (Smith, Commissioner, concurring in the result). The statement was to the effect that the focus of insider trading should be to police the conduct of insiders.

69. *But see infra* note 157 and accompanying text.

circumstances" from which can be inferred the requisite motivation.[70] The Court omitted describing what constitutes "objective facts and circumstances." Instead, Justice Powell recited two possible situations involving requisite motivation: 1) the insider receives something of value in return for the information, and 2) the insider exploits the information by giving it to a friend or relative.[71] It is unclear whether the majority meant to limit the motivational requirement to those two situations, or whether the situations are just two of many unknown "objective facts and circumstances."[72]

The majority summarized by holding that Secrist clearly had no personal motivation.[73] Without motivation, he did not breach his fiduciary duty.[74] Therefore, Dirks could not have derivatively breached that duty.[75] Since he did not breach, Dirks could not be liable under Rule 10b-5 as a "tippee."[76] The judgment of censure was therefore reversed.[77]

Of note is the majority's approval in a footnote of the doctrine known as that of the "constructive insider."[78] The doctrine was not crucial to the case; rather, it was merely dicta. Moreover, the Court simply restated a pre-existing concept in securities law. The doctrine, however, has received widespread attention. The constructive insider doctrine and its effect are discussed in Section IV, Part D of this casenote.[79]

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70. 103 S. Ct. at 3266.

71. *Id.* The majority reached this conclusion by citing a comment by Professor Brudney. Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws,* 93 HARV. L. REV. 324, 348 (1979). But as the dissent pointed out, Professor Brudney merely recognized that the most common motive for breaching one's fiduciary duty is personal gain. 103 S. Ct. at 3270 n.6 (Blackmun, J., dissenting).

72. The Court simply neglected to explicate further.

73. "[Secrist] received no monetary or personal benefit. . . . [T]he tippers were motivated by a desire to expose the fraud." *Id.* at 3267-68.

74. *Id.* at 3267.

75. "[T]here was no derivative breach by Dirks." *Id.* at 3268.

76. "Dirks therefore could not have been 'a participant after the fact in [an] insider's breach of a fiduciary duty.'" *Id.* (quoting *Chiarella,* 445 U.S. at 320 n.12).

77. 103 S. Ct. at 3268. After stating their new ruling, the majority applied the rule with little analysis. Basically, the majority stated the case hinged on Secrist's intent which they viewed, without discussion, as laudable. *Id.* at 3266-68.

78. 103 S. Ct. at 3261 n.14.

79. *See infra* notes 147-53 and accompanying text.

B. The Dissent

Justice Blackmun, writing for the dissent,[80] chided the majority for imposing "a new, subjective limitation on the scope of the duty owed by insiders to shareholders."[81] The dissent viewed the holding as another opinion limiting the scope of section 10(b), thereby frustrating the congressional intent of protecting investors from detrimental and fraudulent practices.[82] The dissent pointedly indicated the majority had no support for its holding.[83]

The dissent began its analysis by illustrating the scope and purpose of an insider's fiduciary duty. The duty is imposed so as to prevent unfair injury to shareholders.[84] The focus of the duty is on the insider's actions and the resulting effect on the shareholders; the focus is not on the insider's motives.[85] Thus, the dissent concluded the majority's motivational requirement was not only ill-imposed, but also contrary to the doctrine of fiduciary duty and to the purposes underlying the Exchange Act from which Rule 10b-5 is derived.[86]

Even with the addition of the motivational requirement, however, the dissent believed that Secrist had the requisite personal motivation.[87] Secrist contacted Dirks with the intention that Dirks pass the information on to his clients who would then unload their stock on the unsuspecting market.[88] Secrist's intent, the dissent stated, was to injure the present and subsequent shareholders of Equity Funding stock.[89] However, Secrist had a duty to those purchasers to disclose.[90] This he failed to do; consequently, he breached his fiduciary duty.[91] Because Dirks knew of

80. In addition to Justice Blackmun, the dissenters included Justice Brennan and Justice Marshall.

81. 103 S. Ct. at 3270 (Blackmun, J., dissenting).

82. *Id.* at 3268.

83. "The novelty of this limitation is reflected in the Court's lack of support for it." *Id.* at 3270 (footnote omitted).

84. "That relationship assures the shareholder that the insider may not take actions that will harm him unfairly." *Id. See also id.* at n.8.

85. "The duty is addressed not to the insider's motives, but to his actions and their consequences. . . ." *Id.* at 3271 (footnote omitted).

86. Justice Blackmun presented a wealth of authority for his views. He demonstrated that prohibiting personal gain is only one of many purposes behind the securities laws. He also examined the scope of the insider's fiduciary duty and how it is breached. *Id.* at 3270-72.

87. The dissent believed Secrist "intended Dirks to injure the purchasers of Equity Funding securities to whom Secrist had a duty to disclose." *Id.* at 3270.

88. "Secrist *used* Dirks. . . ." *Id.* (emphasis added).

89. *See supra* note 87.

90. 103 S. Ct. at 3269-70.

91. The dissent pointedly indicated "[n]o one questions that Secrist himself could not trade on his inside information." *Id.* at 3269. Moreover, the dissent stressed that even the majority admitted "Secrist could not do by proxy what he was prohibited from doing personally." *Id.* at 3270 (citing 103 S. Ct. at 3263).

Secrist's intent and of the breach, Dirks aided and abetted the violation of Rule 10b-5.[92]

Justice Blackmun also objected to the majority's policy wherein the end justifies the means.[93] Secrist and Dirks exposed a massive fraud at Equity Funding. The dissent believed that the majority held that Dirks should not be censured because the overall public benefit outweighed the harm to the shareholders who traded with Dirks' clients.[94] The dissent could not subscribe to a result which rewarded Dirks for taking advantage of, while helping to expose, the fraud at Equity Funding.[95]

The dissent concluded both Secrist and Dirks violated their duties to disclose or abstain, thereby violating section 10(b) and Rule 10b-5.[96] Moreover, because Dirks was himself liable, the dissent stated it was irrelevant that the SEC did not bring an action against Secrist.[97] Overall, the dissent believed the majority opinion would allow crafty insiders to trade up and tip with impunity, thus "opening a hole in the congressionally mandated prohibition on insider trading. . . ."[98] Henceforth, Justice Blackmun feared, insiders and their "tippees" will be rewarded for their cunning in obtaining covert gains.[99]

V. ANALYSIS[100]

A. *Evidence of a Crime Constitutes Inside Information*

The SEC found, and the District of Columbia Court of Appeals

92. Dirks was the person who caused his clients to trade; the trading without disclosure was the violation. 103 S. Ct. at 3274 (Blackmun, J., dissenting).

93. Justice Blackmun wrote: "The Court justifies Secrist's and Dirks' action because the general benefit derived from the violation . . . outweighed the harm caused . . . in other words, because the end justifies the means." *Id.* at 3272-73.

94. *Id.*

95. The dissent believed, "Under this view, the benefit conferred on society . . . may be paid for with the losses caused to shareholders trading with Dirks' clients." *Id.* at 3273 (footnote omitted). The dissent continued by reminding the majority, "A person cannot condition his transmission of information of a crime on a financial award." *Id.*

96. "Any other result is a disservice to this country's attempt to provide fair and efficient capital markets." *Id.* at 3274.

97. "The fact that the SEC . . . did not charge Secrist . . . says nothing about the applicable law." *Id.* at 3273 n.16.

98. *Id.* at 3274.

99. *Id.* at 3273-74.

100. Before the final *Dirks* decision was announced, the case had received widespread analysis. *See* Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 337-38; Heller,

agreed, that the information of a massive fraud, passed from Secrist to Dirks, constituted material inside information. The majority, however, avoided the issue; they assumed the findings below were correct for the purpose of deciding the remainder of the case.[101] In contrast, the dissent impliedly indicated the information was indeed inside and material.[102]

The issue should have been determined. It was of utmost importance to the final decision of the case. The issue had been determined in the SEC administrative proceeding[103] and affirmed by the Court of Appeals.[104] Dirks sought review of the issue in his petition for writ of certiorari.[105] Dirks, the SEC, and the United States Solicitor General briefed the issue to the Supreme Court.[106] Of greater import, had the Court determined the information was *not* material and inside, the opinion would have ended there—the decision as to the issue of "duty" would have been unnecessary. Therefore, the majority should have confronted the issue rather than merely assume the correctness of the determination for purposes of the *Dirks* opinion alone. Consequently, the question remains open.

The question is easily answered. Inside information is defined as nonpublic facts concerning the business of an issuer which, in the usual case, are intended to be available only for a corporate purpose.[107] Applying this definition to the facts in *Dirks,* the evidence of a crime, namely fraud, clearly constituted material inside information.

First, the information was clearly nonpublic. The fraud had continued over a period of years without being exposed.[108] Al-

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Chiarella, *SEC Rule 14e-3 and* Dirks: *"Fairness" versus Economic Theory,* 37 BUS. LAW. 517 (1982); Herman, *Equity Funding, Inside Information, and the Regulators,* 21 UCLA L. REV. 1 (1973); Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement,* 70 CALIF. L. REV. 1, 30-33 (1982); Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy,* 9 J. LEGAL STUD. 801, 813-14 (1980).

101. The Court merely stated: "We need not decide [the issue]." 103 S. Ct. at 3266 n.25. The Court, without justification, gave no reasons why. One possible reason for refusing to explicitly rule on the issue could be fear of riling Congress and thereby further delaying the passage of the Insider Trading Sanctions Act of 1983. Exercising a bit of judicial cunning, Justice Powell, however, hinted how the Court might later rule: "[W]e *assume* the correctness of the SEC's findings . . . that [Dirks] was a tippee of *material inside information.*" *Id.* (emphasis added).

102. "Secrist . . . could not trade on *his inside information.* . . ." 103 S. Ct. at 3269 (Blackmun, J., dissenting) (emphasis added).

103. Initial Decision, *supra* note 37.

104. Dirks v. Securities and Exch. Comm'n, 681 F.2d 824 (1982).

105. Petition for Writ of Certiorari at 21-25.

106. *See* Brief for Petitioner at 28-31; Brief for Respondent at 45-49; Brief of the United States as Amicus Curiae at 18-26.

107. *See supra* note 13.

108. "[Equity Funding] had made bogus entries in its books since 1964 and, be-

though an occasional rumor may have surfaced throughout the years, the integrity of Equity Funding remained intact. The first public report concerning the Equity Funding fraud did not appear until the Wall Street Journal published an article on April 2, 1973, based on Dirks' information.[109]

Second, the requirement that inside information contain "facts" is not limited to presently existing circumstances; it includes opinions, estimates, and predictions.[110] Thus, it was irrelevant that Secrist initially tipped the information without any "hard" documentation.[111] Secrist's opinion that ongoing fraud existed—which Dirks believed—was sufficient.

Third, the information of fraud concerned the business. In fact, the fraud not only went to the heart of the business, but also consisted of almost two-thirds of Equity Funding's ostensibly issued life insurance policies.[112] Tangentially, the information also concerned the market for Equity Funding's securities, for once the fraud was publicly disclosed, the market was sure to plunge.[113]

Fourth, some authorities conclude that to be inside, the information must have been intended for a corporate purpose.[114] However, if the inside information concerns the market for the security, this element is usually not required. Moreover, whenever required, it is usually satisfied where the tip concerns a company's business.[115] As indicated, the information concerned the

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ginning in 1970, had manufactured increasing amounts of wholly fictitious insurance." *In re* Dirks, [1981] Fed. Sec. L. Rep. (CCH) § 82,812, at 83,944 (footnote omitted).

109. Dirks v. Securities and Exch. Comm'n, 103 S. Ct. 3255, 3259 (1983).

110. 5A JACOBS, *supra* note 7, section 66.02[b], at 3-454.

111. Secrist did not offer Dirks any "hard" information, *e.g.*, documents. It is highly unlikely that he could have in view of the fact that traces of fraud were so well covered. Instead, he merely informed Dirks that he had discovered through contacts that a massive fraud was under way. Dirks v. Securities and Exch. Comm'n, 681 F.2d 824, 830 (1982).

112. "Of more than $3 billion worth of life insurance ostensibly issued by EFCA [Equity Funding], over $2 billion proved to be fictitious. More than $85 million in purported profits had been generated by the fraudulent scheme." *In re* Dirks, [1981] Fed. Sec. L. Rep. (CCH) § 82.812 at 83,944 n.19.

113. The market to sell or buy a firm's securities can easily be touched off. For example, a report of changes in dividend rates can raise or lower the price of the firm's securities. Herman, *Equity Funding, Inside Information, and the Regulators,* 21 UCLA L. REV. 1, 10 n.39 (1973). It thus becomes evident that a public disclosure that two-thirds of Equity Funding's life insurance policies were nonexistent would be certain to send the price of its stock on a downward spiral.

114. *See* 5A JACOBS, *supra* note 7, section 66.02[b], at 3-454 to -446.

115. *Id.*

tip; this element is therefore satisfied.

Finally, the size and scope of the fraud indicated its materiality. The tip would be sure to influence any investor's decision to buy or sell. Moreover, the materiality is enhanced when the information of the tip—i.e., the knowledge of the ongoing fraud—is coupled with the knowledge that public disclosure of the fraud is imminent. Any investor would sell stock today to limit losses rather than watch his fortune become completely worthless tomorrow. Without doubt, the tip of ongoing fraud was material nonpublic inside information.

B. The Personal Motivation Requirement

The majority in *Dirks* held a fiduciary does not breach his fiduciary duty absent personal gain.[116] This far-reaching decision is without support. The majority based its holding on a footnote from *Cady* that one of the purposes of securities laws is to prevent personal gain through the use of inside information.[117] In so holding, the Court not only ignored the other purposes of the Exchange Act, section 10(b), and Rule 10b-5—most importantly, protection of investors and fairness—but also effectively eliminated those purposes from Rule 10b-5. Moreover, the Court rewrote the concept of fiduciary duty;[118] an insider-fiduciary can now harm a company's shareholders without liability so long as he does not personally benefit.

Two of the basic policies of the Exchange Act from which Rule 10b-5 stems are fairness and the protection of investors.[119] Justice Powell and the majority in effect recognized these principles in their restatement of the *Cady* rule in *Chiarella:* "The Commission emphasized that the duty arose from . . . the *unfairness* of allowing a corporate insider to take advantage of that [inside] information by trading without disclosure."[120] If an insider is allowed to make unfair use of inside information, investors—including subsequent shareholders—are not protected. Therefore, in order to uphold these congressionally mandated policies, the *Chiarella* Court adopted the rule of the Restatement (Second) of Torts[121] that "the duty to disclose arises when one party has information

116. 103 S. Ct. at 3265. *See supra* notes 66-68 and accompanying text.

117. *See supra* note 68 and accompanying text.

118. *But see* Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 26 (1976) (The Court "must be wary against interpolating [its] notions of policy in the interstices of legislative provisions."); Bank v. Sherman, 101 U.S. 403, 406 (1879) ("It is our business to execute the law as we find it, and not to make or modify it.").

119. *See supra* notes 15-19 and accompanying text.

120. Chiarella v. United States, 445 U.S. 222, 227 (1980) (quoting *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 n.15 (1961)).

121. RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1977).

'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.' "[122] In short, the fiduciary relation alone requires disclosure before trading or tipping based upon material inside information. If an insider trades (or tips and the "tippee" trades) without disclosure, then a breach of the fiduciary duty occurs—*regardless of the motivation of the insider-fiduciary.*

Joining the policies of the Exchange Act (and Rule 10b-5 promulgated thereunder)[123] with the decision of *Chiarella* and the fiduciary duty concept,[124] Rule 10b-5 clearly was intended only to prohibit, among other fraudulent practices, the use of inside information for personal gain. Neither Congress nor the SEC intended to make personal motivation or personal gain an *element* of a Rule 10b-5 violation.[125] It follows that a breach of the fiduciary duty is sufficient to impose liability for a violation of Rule 10b-5.[126] As such, the additional requirement of personal motivation was groundless.

Why did the Court impose the personal benefit requirement on the fiduciary duty concept? This question undoubtedly will be long debated. One possible reason for the majority's action is be-

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122. 445 U.S. at 228 (1980).

123. *Cf.* United States v. Naftalin, 441 U.S. 768, 774-75 (1979) (primary purposes of the Securities Act of 1933 are the protection of investors, and "to achieve a high standard of business ethics . . . *in every facet of the securities industry.*") (quoting S.E.C. v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186-87 (1963) (emphasis added)).

124. *See* Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement,* 70 CALIF. L. REV. 1 (1982) (discussing the fiduciary duty).

125. *See* 5 JACOBS, *supra* note 7, sections 5, 5.01 and 5.02 (discussing the legislative history of section 10(b) and Rule 10b-5).

126. In Chiarella v. United States, 445 U.S. 222, 230 n.12 (1980), the Court stated:

> "Tippees" of corporate insiders have been held liable under § 10(b) because they have a duty not to profit from the use of inside information that they know is confidential and know or should know came from a corporate insider. . . . The tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty.

The first sentence of the quote seems to imply that even where the insider/"tipper" does not breach his fiduciary duty, the "tippee" can still be held liable for trading based upon the tipped inside information. The second sentence of the quote seems to contradict the first; specifically the insider must first breach his fiduciary duty before the "tippee" can be held liable for subsequent trading. The Court finally cleared up the discrepancy in *Dirks* by holding the insider must first breach before a "tippee" can be held liable. *But see* 5A JACOBS, *supra* note 7, section 66.02[a][iii][C], at 3-439 (offering three considerations demonstrating a "tippee" should be held liable for insider trading although the "tipper" breached no fiduciary duty).

cause Dirks played a major role in exposing a massive fraud. The fraud had continued for nine years before Dirks' efforts helped bring about public disclosure. By his actions, Dirks had achieved a beneficial result for the general public good. In some respects, he could be considered a "hero."[127]

A second possible reason for the ruling is that the Court was greatly influenced by the United States Solicitor General. The Solicitor General authorized the SEC to oppose Dirks' appeal; he sided, however, with Dirks. In opposition to the SEC, the Solicitor General echoed Dirks in urging that the petition for writ of certiorari be granted. After the Court agreed to hear the case, the Solicitor General filed a lengthy brief as amicus curiae in support of Dirks.[128]

Neither reason, however, was sufficient to support the Court's ruling. Dirks' censure did not discourage or inhibit insurance analysts in their investigative roles. The Court cited no evidence indicating analysts had become inhibited since the censure was originally imposed on Dirks. The imposition of the censure merely indicated analysts must perform their duties honestly; the information must first be disclosed to the public before an analyst may use it to his own, and/or his client's, personal advantage. In sum, no basis in either the legislative history of the securities laws or in public policy existed for the announcement of the personal motivation requirement. The requirement was ill-conceived and wrongly imposed.[129]

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127. A "hero" is normally not censured for his "heroic" conduct. The majority did not want to censure Dirks for this conduct. However, the Court faced a problem: under existing law, Secrist had breached his fiduciary duty to Equity Funding shareholders and purchasers by causing undisclosed trading in Equity Funding securities based upon inside information passed along to Dirks. Dirks aided and abetted the breach by selectively tipping Delafield Childs' clients. In short, Dirks had violated Rule 10b-5. The majority, therefore, needed a way to get Dirks off the hook. Their method was the imposition of the personal motivation requirement.

128. The SEC filed an opposition brief to Dirks' petition for a writ of certiorari. The Solicitor General authorized the brief, but refused to join. Instead, he inserted a footnote at the close of the SEC brief contradicting the SEC's arguments and urging Dirks' petition be granted. After the granting of the petition, the Solicitor General submitted a brief as amicus curiae in support of Dirks' position.

Clearly, Dirks' attack on the SEC's position was backed by the full weight of the United States Government. Of course, the United States does not win all of its cases, nor does it coerce the Supreme Court into succumbing to its wishes. However, with the United States siding against one of its most respected administrative agencies and urging the overturning of Dirks' censure was essential in order to preserve the investigative role of insurance analysts, the Supreme Court could not help but be influenced.

129. "Even on the extraordinary facts of this case, such an innovation is not justified." 103 S. Ct. at 3268 (Blackmun, J., dissenting).

C. *Was Rule 10b-5 Violated?*

1. Fiduciary Duty Theory

Clearly, without the new motivational requirement, Secrist breached his fiduciary duty. He tipped Dirks who in turn tipped clients who traded without disclosure. Under *Chiarella,* this constituted a breach of duty by Secrist. Dirks then became liable for his derivative breach of tipping to clients who traded without disclosure.

The majority, however, imposed the motivational requirement on the fiduciary duty. The issue then became what was Secrist's intention in tipping without disclosure. The Court debated the issue. The majority simply stated Secrist intended only to expose the Equity Funding fraud;[130] Justice Powell stated his conclusion but proffered little analysis. The dissent, however, was wary of the new requirement; they scrutinized Secrist's motives more closely.

Secrist had been fired from his office at Equity Funding. He subsequently informed Dirks of what he believed concerning the fraudulent practices at Equity Funding.[131] However, in order that he not "look like a disgruntled employee trying to get even . . .",[132] Secrist told Dirks he had quit his Equity Funding job. Moreover, Secrist wanted the information passed to Dirks' clients.[133] His stated intentions were to "jar" the stock price and the corporate officers,[134] to bring the stock price "close to zero very quickly"[135] and "to put on as much heat as possible and as fast as possible."[136]

In view of his testimony, Secrist intended for much more to occur than the mere public disclosure of the fraud.[137] The dissent concluded Secrist intended to injure subsequent shareholders of

130. Dirks v. Securities and Exch. Comm'n, 103 S. Ct. 3255, 3268 (1983).

131. Joint Appendix of Appellant and Respondent at 14-28 (testimony of Ronald Secrist before hearing examiner).

132. Secrist was afraid that telling Dirks he had been fired "would cloud the issue." *Id.* at 20.

133. Secrist stated: "I expected him [Dirks] to disseminate this information to his firm's customers, clients." *Id.* at 25.

134. *Id.* at 16.

135. *Id.* at 27.

136. *Id.* at 16.

137. The author is not passing judgment upon Mr. Secrist's actions or intentions. Rather, the author is merely summarizing Mr. Secrist's testimony and the opinion of the dissent. The reader is left to draw his own conclusions.

Equity Funding for unknown personal reasons. The dissent felt, however, that Secrist's intentions were sufficient to satisfy the personal motivation requirement. Secrist's personal gain was the achievement of his intended goal. Therefore, Secrist breached his fiduciary duty. Dirks was liable for the derivative breach.[138] The dissent had more support for their position than did the majority. In short, the dissenters had the better reasoned analysis demonstrating a breach of fiduciary duty.[139] With or without the new motivational requirement, Dirks violated Rule 10b-5 under the fiduciary duty theory.

2. Misappropriation Theory

The misappropriation rule prohibits the recipient of information from another (whether or not obtained by misappropriation) "from converting the information to his own personal ends (if it was not so intended) by trading on the basis of information or by tipping someone else who so trades."[140] Liability pivots on two issues: 1) whether the information was created by another, and 2) whether the information was intended to be a basis for trading or tipping.[141] The fiduciary duty theory and the misappropriation theory are not mutually exclusive.[142]

The dissent did not reach the question of misappropriation although statements by Justice Blackmun alluded to it.[143] The majority, however, flatly stated that Dirks was not guilty of misappropriation.[144] This bold statement of the majority was also the extent of their analysis into the misappropriation question. Consequently, this flat pronouncement cannot plausibly be considered an inroad into the theory. As a result, the theory remains viable.

In order to find a violation of Rule 10b-5 under the misappropriation theory, the focus must be placed upon the actions of both the "tipper" and the "tippee." Secrist did not create the information of the fraud—i.e., he was not the source of the information.

138. 103 S. Ct. at 3270, 3274 (Blackmun, J., dissenting).

139. If the personal motivation requirement must be imposed, it should be given a liberal application—as demonstrated by the dissent. Otherwise, the SEC is apt to face insurmountable burdens of proof in some cases. *See infra* notes 157-59 and accompanying text.

140. 5A JACOBS, *supra* note 7, section 66.02[a][iii][C], at 3-443.

141. "The liability of a trading of tipping defendant under the misappropriation theory . . . turn on two issues: (1) Did the defendant create the information? (2) Was the information intended as a basis for his trading or tipping?" *Id.*

142. *Id.* at section 66.02[a][iii][B], at 3-430.

143. "[Dirks] should not profit from the information [he] obtained from Secrist." 103 S. Ct. at 3273 (Blackmun, J., dissenting).

144. "Nor did Dirks misappropriate . . . the information about Equity Funding." *Id.* at 3267.

Secrist merely learned of the information from others while at Equity Funding and passed it on. Whether or not Secrist intended Dirks to further tip or trade is therefore irrelevant. "Permission to trade or to tip must derive from the source of the information. A tipper's permission alone will not allow a tippee to trade or to tip others."[145] Dirks used the information for his own benefit (commissions and enhanced reputation) by tipping to clients who traded without disclosure. In sum, Dirks received information created by another, the information was not intended as a basis for trading or tipping,[146] and he used the information for his own benefit. As a result, Dirks violated Rule 10b-5 under the misappropriation theory.

*D. Post-*Dirks *Fallout: The "Constructive Insider"*

Since the announcement of the *Dirks* decision, considerable attention has been paid to footnote 14 of the majority opinion. The footnote reads in pertinent part:

> Under certain circumstances . . . outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is . . . that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes. [citations]. When such a person breaches his fiduciary relationship, he may be treated more properly as a tipper than a tippee. [citation]. For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.[147]

The rule the Court stated concerning these "outsiders" has come to be known as the doctrine of the "constructive insider." This doctrine has been heralded as a new method for the SEC to police insider trading.[148] The SEC has even gone so far as to claim the *Dirks* decision was "an enormous victory" because of footnote 14.[149]

However, the concept of the "constructive insider" may not be

145. 5A JACOBS, *supra* note 7, section 66.02[a][iii][C], at 3-446 to -447.

146. The source of Secrist's information was with those who created and conducted the Equity Funding fraud, not with Secrist. There is no evidence (and it is also unlikely that) those who perpetrated the fraud intended their shareholders' trade based upon the information.

147. Dirks v. Securities and Exch. Comm'n, 103 S. Ct. 3255, 3261 n.14 (1983).

148. 15 Sec. Reg. & L. Rep. (BNA) No. 32, at 1562, No. 38, at 1820-22; No. 40, at 1912, No. 44, at 2070.

149. *Id.* No. 49, at 2261 (remarks of SEC Enforcement Director John Fedders in the December 16, 1983 issue).

as new as some authorities believe. Actually, the concept is rooted in the SEC administrative proceeding of *Cady:*

> [Officers, directors, and controlling shareholders] do not exhaust the classes of persons upon whom there is such an obligation [to disclose]. . . . In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. 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.[150]

By comparing the quotation from *Cady* with that from *Dirks,* it is clear the underlying concept is the same. Only the manner of expression is different. One commentator had previously termed these persons as "access insiders."[151]

Consequently, the footnote 14 "constructive insider" is not deserving of the attention it has received. The Court merely stated a preexisting rule; only the name is new. The concept adds nothing to the SEC arsenal not already present. The footnote, however, although not "an enormous victory," was an awakening. The doctrine had been in disuse for well over a decade.[152] Only with the *Dirks* decision has the SEC realized the importance and usefulness of the doctrine. For example, the constructive insider doctrine, if applicable, could be an alternative theory of liability where the SEC is unable to demonstrate an insider's breach. In sum, although the doctrine is anything but new, it can be expected to be utilized frequently by the SEC in the future. In fact, the SEC has already argued the concept to victory.[153]

E. Impact

The impact of *Dirks* will be far-reaching and varied. First, the Court's motivational requirement effectively eliminated from Rule

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150. *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961) (footnote omitted).

151. 5A JACOBS, *supra* note 7, section 66.02[a][iii][C], at 3-438. *See also* Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws,* 93 HARV. L. REV. 322 (1979) (discussing the "outsider" concept).

152. The most recent use the SEC has made of the doctrine seems to be in a 1971 release. Investors Management Co., Exchange Act Release No. 9267 (July 29, 1971) (underwriter and its personnel—including salesmen—are insiders).

153. Securities and Exch. Comm'n v. Lund, 570 F. Supp. 1397 (C.D. Ca. 1983). Lund was found to have received material nonpublic inside information upon which he traded without disclosure. The case was taken under submission at the close of the trial. Prior to a final opinion, the *Dirks* decision was announced. The trial court allowed both parties to argue the impact of *Dirks.* Subsequently, the court found Lund not liable as a "tippee"; instead, the court utilized footnote 14 from *Dirks* to find Lund liable as a "temporary insider." *See also* Securities and Exch. Comm'n v. Musella, 578 F. Supp. 425 (S.D.N.Y. 1984) (order granting preliminary injunction from Rule 10b-5 violations and finding a law firm employee a "temporary insider."). *But see* Moss v. Morgan Stanley Inc., 719 F.2d 5, 15 (2d Cir. 1983) (holding the defendants were not constructive insiders).

10b-5 the policies of fairness and of investor protection.[154] As a result, the insider trading doctrine has been transformed from a rule protecting the market to a rule merely policing insiders. In turn, the incidence of insider trading and tipping may well rise. Common knowledge indicates the SEC is understaffed in view of the volume of activities for which it is responsible. Insiders now have good reason to believe the SEC will be less apt to enforce a borderline case.

Second, the imposition of the motivational requirement will greatly enlarge the administrative and judicial burden in Rule 10b-5 insider trading cases. Previously, an insider was presumed to have gained by tipping where he knew the "tippee" would trade on the information.[155] With the addition of the new *Dirks* requirement, however, the presumption is extinguished. A case-by-case determination is now required.

In addition, the SEC has an added pleading requirement. Because the Court made personal motivation an element of Rule 10b-5, the SEC must always plead motivation. This could quickly become routine in insider trading cases.[156] It is uncertain, however, whether courts will allow the SEC to simply plead that a benefit was received by the insider, or whether courts will require complaints be narrowly drawn, containing specific concrete allegations of the personal gain received. Utilizing a reasonably liberal construction, only the former should be required. If this is so, the added burden of pleading will be minimal.

The greater problem for the SEC will be its proof requirement. The majority admitted, "[d]etermining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts."[157] That most certainly is true. But if the courts will have difficulty viewing the evidence, then the SEC's burden of proof will be ever so great indeed. The problems of proof in some cases may be insurmountable. To combat this proof problem, the Court offered "objective criteria, *i.e.*, whether the insider receives a direct or indirect personal benefit.

154. *See supra* note 118 and accompanying text.
155. 103 S. Ct. at 3272 n.13 (Blackmun, J., dissenting).
156. *See, e.g.*, SEC Complaint for Injunctive and Other Equitable Relief, Securities and Exch. Comm'n v. Thayer, No. 84-0066 (S.D.N.Y. filed Jan. 5, 1984) ("As part of this violative conduct, Thayer, for his direct or indirect personal benefit. . . ."), *reprinted in* Practicing Law Institute, The SEC Speaks in 1984, at 195, 200 (J. Fedders & D. Scharff, Co-chairmen 1984) [hereinafter cited as SEC Speaks].
157. Dirks v. Securities and Exch. Comm'n, 103 S. Ct. 3255, 3266 (1983).

. . ."[158] But unless the insider is blatantly obvious in reaping his reward, the SEC will be hard pressed to demonstrate the benefit received. Personal benefits—especially indirect benefits—are quite easily concealed.

Consequently, the SEC can be expected to concentrate on its stronger cases; its weaker cases will be left unprosecuted. A crack in the congressional prohibition of insider trading will appear as the dissent had feared. In those cases where a personal motivation is not clearly obvious, insider trading by insiders and "tippees" will proliferate, undaunted by the SEC's enforcement efforts.

However, the SEC should be able to keep the crack from growing too wide. For one thing, the SEC can rely on the courts to broadly construe what is a personal motivation or personal benefit. First, a "personal gain" can mean many things in different factual contexts. Second, insider trading is both a legal and moral wrong.[159] Accordingly, courts will be disinclined to reward those insider traders who violate the equitable principle of fairness at the expense of unsuspecting and unprotected investors. Finally, the other way the SEC can keep insider trading in check is by attacking the insiders and "tippees" on a broader legal base; in addition to the duty theory, the SEC should utilize the misappropriation theory and the constructive insider doctrine wherever possible. The SEC is sure to do so.

The SEC must take the initative. First, it could amend Rule 10b-5 or replace it altogether so as to clarify the specific proscribed conduct.[160] In this manner, the SEC could indicate its response to the personal benefit requirement. Second, the SEC could promulgate a release indicating how an insider or "tippee" subject to the "disclose or abstain" rule can accomplish an effective disclosure before trading. Obviously, greater guidance is necessary. However, the Court's "guiding principle"[161] (i.e., the motivational requirement) is not only insufficient, but also contrary to congressional policies underlying the Exchange Act. The SEC was appointed the task of upholding those policies. The

158. *Id.*

159. *See, e.g.,* 15 Sec. Reg. & L. Rep. (BNA) No. 44, at 2070 (remarks of David Ferber); Written Statement of the Honorable John S. R. Shad, Chairman, Securities and Exchange Commission, Before the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Energy and Commerce Committee Concerning the Insider Trading Sanctions Act (Apr. 13, 1983), *reprinted in* SEC Speaks, *supra* note 156, at 47.

160. Four months after the decision in *Chiarella,* the SEC responded by promulgating Rule 14e-3 under the Exchange Act. S.E.C. Rel. 34-17120. 45 Fed. Reg. 60,410 (1980). The SEC could do likewise here.

161. 103 S. Ct. at 3266.

SEC now has an opportunity to act.[162]

VI. CONCLUSION

In a far-reaching decision, the Supreme Court etched a new and unprecedented concept into the rules of insider trading. The Court added a new element to Rule 10b-5 by holding that absent a personal motivation an insider does not breach his fiduciary duty to shareholders by trading on inside information. This new rule violated the spirit of the Exchange Act by undermining its policies. In addition, the prescript changed the role of the insider/fiduciary—he is now liable under Rule 10b-5 only for wrongful conduct from which he personally benefits.

The motivational requirement will have an inhibiting effect on SEC enforcement of laws prohibiting insider trading. Because of the added weight to its already heavy burden of proof, the understaffed SEC can be expected to enforce only those cases where a personal motivation is clearly obvious. Consequently, an area of currently prohibited insider trading will arise which will be left unchecked. Within this gap, instances of insider trading will increase and SEC enforcement actions will decrease. However, the SEC will be able to stultify the growth of the gap by utilizing more often the misappropriation theory and the doctrine of constructive insider. Even so, those theories also have difficult proof requirements. The likely result is that investors will receive less protection and confidence in the securities market will erode.

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162. Congress can also take action to clarify its position as to the purposes and scope of the Exchange Act and section 10(b). Presently, however, Congress' attitude is to "wait and see" before taking any action. Insider Trading Sanctions Act of 1983, H.R. REP. No. 98-355, 98th Cong., 1st Sess. 15 ("[T]he Committee directs the [SEC] to monitor the effects of *Dirks* for at least two years and report back. . . ."), *reprinted in* SEC Speaks, *supra* note 156, at 899.