

CASE COMMENTS

TIPPEE LIABILITY UNDER RULE 10B-5 PREDICATED ON WHETHER TIPPER TIPS TO SECURE PERSONAL BENEFIT

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

Raymond Dirks, an investment analyst, received inside information relating to massive fraud in the internal operations of Equity Funding Corporation of America (EFCA).¹ Dirks alerted several of his institutional clients,² which thereafter liquidated a substantial portion of their EFCA holdings, causing a precipitous decline in the stock's value.³

An SEC investigation of Dirks' activities culminated in a hearing before an administrative law judge, who found Dirks guilty of aiding and abetting violations of the antifraud provisions of the federal securities laws,⁴ including section 17(a) of the Securities Act of 1933,⁵ section 10(b) of the Securities Exchange Act of 1934,⁶ and SEC rule 10b-5.⁷

1. *Dirks v. SEC*, 103 S. Ct. 3255, 3258 (1983). The "tipper," Ronald Secrist, was a former officer of Equity Funding Corporation of America (EFCA). After various regulatory agencies failed to act on allegations that EFCA's assets were vastly overstated, Secrist revealed the fraudulent scheme to Dirks. He hoped that Dirks, an investment analyst, would verify the fraud in the course of his normal investigatory procedures and expose it to the public. *Id.*

2. *Id.* Dirks' clients liquidated at least \$16 million worth of EFCA stock.

3. *Id.* at 3258-59. When a deluge of "sell" orders hit the market, EFCA's stock fell from \$25 per share to less than \$15 per share. As a result of this drop, the New York Stock Exchange halted trading of EFCA stock. Immediately following the halt, the Securities Exchange Commission (SEC) and California insurance authorities launched a full-scale investigation of EFCA which finally exposed the fraud. *Id.* This scenario corresponded exactly with Secrist's wishes. *Id.* at 3268 (Blackmun, J., dissenting).

4. *In re Boston Co. Inst'l Investors, Inc.*, 1978 Fed. Sec. L. Rep. (CCH) ¶ 81,705, at 80,816 (S.D.N.Y. 1978). The administrative law judge suspended Dirks from association with any registered broker for sixty days and censured four institutions which had traded large blocks of EFCA stock after receiving tips from Dirks. *Id.* at 80,867.

5. 15 U.S.C. § 77q(a) (1982). Section 17(a) prohibits fraud, misrepresentations or material omissions in the offer or sale of any security.

6. 15 U.S.C. § 78j(b) (1982). Section 10(b) prohibits the use of manipulative or deceptive devices in connection with the purchase or sale of securities.

7. 17 C.F.R. § 240.10b-5 (1982). Rule 10b-5 provides in pertinent part:

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

- 1) to employ any device, scheme, or artifice to defraud,
- 2) to make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statement made, in light of the circumstances under which they were made, not misleading, or
- 3) to engage in any act, practice, or course of business which operates or would oper-

On appeal, the SEC reduced Dirks' sanction to censure,⁸ and the Court of Appeals for the District of Columbia affirmed.⁹ The United States Supreme Court granted certiorari, reversed the judgment of the court of appeals, and *held*: The duty of a tippee to disclose or abstain from trading on inside information derives from the fiduciary duty the insider-tipper owes the corporation's shareholders.¹⁰ If the insider's purpose for tipping is not to secure a personal gain, he does not breach his fiduciary duty and the tippee does not breach his derivative duty by trading.¹¹

An insider standing in a fiduciary relationship with corporate shareholders must disclose all material, nonpublic information before he can trade on inside information.¹² This affirmative duty to disclose or refrain from trading has its origin in the common law tort of deceit.¹³

ate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

8. *Dirks v. SEC*, 681 F.2d 824, 833 (D.C. Cir. 1982).

9. *Id.* at 846. Judge Skelly Wright, in an opinion expressing his own reasoning, asserted that Dirks, as a tippee, acquired the same fiduciary obligation Secrist owed EFCA shareholders as a corporate insider: publicly to disclose inside information before trading or to abstain from trading altogether. *Id.* at 839. Alternatively, Judge Wright concluded that Dirks "had obligations to the SEC and to the public completely independent of any obligations he acquired under the Shapiro v. Merrill Lynch doctrine." *Id.* at 840. The Supreme Court declined to consider this alternate approach, determining that this rationale was not properly before the Court. 103 S. Ct. at 3267 n.26. For a discussion of Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228 (2d Cir. 1974), see *infra* note 35.

10. 103 S. Ct. 3255, 3264 (1983).

11. *Id.* at 3265-66. See *infra* notes 36-52 and accompanying text.

12. *Chiarella v. United States*, 445 U.S. 222, 230 (1980). This statement represents the modern elaboration of an insider's fiduciary duty to corporate shareholders. See generally Langevoort, *Insider Trading and the Fiduciary Principle: A Post Chiarella Restatement*, 70 CAL. L. REV. 1, 1-11 (1982) (discussing the evolution of an insider's duty from its common law origins to the present).

13. See, e.g., *Strong v. Repide*, 213 U.S. 419 (1909); *Oliver v. Oliver*, 118 Ga. 362 (1903); *Hotchkiss v. Fischer*, 136 Kan. 530, 16 P.2d 531 (1932); *Goodwin v. Agassiz*, 283 Mass. 358, 186 N.E. 659 (1933). See *infra* notes 14-28 and accompanying text. See also Langevoort, *supra* note 12, at 4 (discussion of the common law deceit action in the context of insider trading); Note, *Rule 10b-5: Scope of Liability Extended as Former Outsiders Become Market Insiders*, 58 NEB. L. REV. 866, 872 (1979) (same) [hereinafter cited as Note, *Market Insiders*]; Note, *Rule 10b-5 and the Duty to Disclose Market Information: It Takes a Thief*, 55 ST. JOHNS L. REV. 93, 96 (1980) (same) [hereinafter cited as Note, *It Takes a Thief*]; Note, *Civil Liability Under Rule X-10b-5*, 42 VA. L. REV. 537, 546 (1956) (same) [hereinafter cited as Note, *Civil Liability*].

In order to recover at common law in a deceit action, a plaintiff had to prove that the defendant misrepresented a material fact with the intent to induce plaintiff's reliance thereon, and that the plaintiff in fact relied on the misrepresentation to his detriment. The common law standard requires that inside information be both *material* and nonpublic. The Supreme Court has suggested that information is material if "the disclosure of the omitted fact would have been viewed by the

Although the common law deceit action clearly provided a remedy for the victims of active misrepresentation, courts disagreed on the question whether a corporate insider could be held liable for failure to disclose material, nonpublic information to individual shareholders.¹⁴

reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). *See, e.g.*, *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 164 (2d Cir. 1980) (corporate director's casual comments not material); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849-52 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) (non-disclosure of discovery of rich ore deposits held material information); *Pachter v. Merrill Lynch, Pierce, Fenner & Smith*, 444 F. Supp. 417, 422 (E.D.N.Y.), *aff'd*, 594 F.2d 852 (2d Cir. 1978) (broker's knowledge of rumors not concrete enough to constitute material information); *Investors Management Co.*, 44 S.E.C. 633, 641 (1971) (non-disclosure of drop in corporate earnings held material information). *See generally* Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 323 (1976) (noting outer boundaries of material, nonpublic information); Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 803-04 (1973) (discussing possible distinction between information material to short-term and long-term investors).

Modern courts refer to the defendant's intent requirement as "scienter." *Aaron v. SEC*, 446 U.S. 680, 691 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976). Proof of scienter is a requisite element of a rule 10b-5 action. 425 U.S. at 197. In *Ernst & Ernst v. Hochfelder*, the Supreme Court held that the word "manipulative" within rule 10b-5 suggests that a defendant must act with a culpable intent greater than "negligence" in order to meet rule 10b-5's scienter requirement. *Id.* at 199. The Court, however, left open the question of whether "recklessness" is sufficient to constitute scienter. *Id.* at 207-09. Lower courts have uniformly held that the scienter requirement is satisfied upon a showing of "reckless conduct." *See, e.g.*, *McLean v. Alexander*, 599 F.2d 1190, 1197 (3d Cir. 1979); *Nelson v. Serwold*, 576 F.2d 1332, 1337-38 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978); *Rolf v. Blyth Eastman Dillon & Co.*, 570 F.2d 38, 44-47 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); *Sunstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1044 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977).

Plaintiffs need not always provide proof of actual reliance on defendants' material misrepresentations. Courts recognize that a showing of actual reliance is impractical, if not impossible, in contemporary impersonal markets such as the stock exchange. Thus, courts hold that when a defendant *fails to disclose* material nonpublic information prior to trading, a modern rule 10b-5 action requires only a showing that the defendant's misrepresentation is one on which the reasonable investor would have relied. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1972). For a discussion of the application of rule 10b-5 in an impersonal market, see *infra* notes 19-26 and accompanying text. When a defendant *actively misrepresents* material facts courts may still require a plaintiff to prove actual reliance as a prerequisite to 10b-5 recovery. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-53 (1972); *Huddleston v. Herman & MacLean*, 640 F.2d 534, 548 (5th Cir. 1981), *aff'd in part, rev'd in part on other grounds*, 103 S. Ct. 692 (1983).

14. Three schools of thought developed. The majority of courts concluded that corporate officials owe a fiduciary duty to their shareholders collectively, but owe no such duty to their shareholders individually. *See, e.g.*, *Hooker v. Midland Steel Co.*, 215 Ill. 444, 74 N.E. 445 (1905); *Goodwin v. Agassiz*, 283 Mass. 358, 186 N.E. 659 (1933); *Voellmeck v. Harding*, 166 Wash. 93, 6 P.2d 373 (1931). Thus, corporate officials were under no obligation to disclose material facts to a stockholder before trading on insider information. One rationale frequently advanced to support this rule was the fear that placing an "onerous" level of fiduciary duty on corporate directors and officers would deter qualified individuals from accepting office. *See, e.g.*, *Goodwin v. Agassiz*, 283

The enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934,¹⁵ (the 1933 and 1934 Acts), and the promulgation of rule 10b-5¹⁶ established the current framework for the governance of insider trading.¹⁷ While rule 10b-5 does not explicitly purport to define

Mass. 358, 361, 186 N.E. 659, 661 (1933). Courts adopting the majority rule, however, recognized the unfairness involved when a corporate insider possessing nonpublic information actively sought a shareholder with whom to trade, knowing that the shareholder was not privy to inside information. *Id.* at 362, 186 N.E. at 661.

A minority of courts held that the fiduciary duty of corporate officials to the corporate entity extended to the shareholders as well, and therefore imposed an affirmative duty on corporate officials to disclose to stockholders all material nonpublic information relating to their shares or abstain from trading. *See, e.g.,* *Oliver v. Oliver*, 118 Ga. 362, 45 S.E. 232 (1903); *Board of Comm'rs v. Reynolds*, 44 Ind. 509 (1873); *Dawson v. National Life Ins. Co.*, 176 Iowa 362, 157 N.W. 929 (1916); *Hotchkiss v. Fischer*, 136 Kan. 530, 16 P.2d 531 (1932).

In *Oliver v. Oliver*, 118 Ga. 362, 45 S.E. 232 (1903), the Georgia Supreme Court rejected the majority view, asserting that the fact that a director owed a fiduciary duty to the corporate entity "is not to be perverted into a holding that he is under no obligation" to the shareholders individually. *Id.* The court asserted that because corporate officers hold a position of the highest trust and confidence, they stand in a quasi-trustee relationship to individual shareholders. *Id.* It is improper, therefore, for officers to take advantage of special nonpublic information to the detriment of the shareholders. *Id.* at 368, 45 S.E. at 234. The court concluded that nondisclosure is fraudulent if the insider "purposefully conceals" material information and uses it to his own advantage. *Id.* Courts today interpret rule 10b-5 as a codification of this position. *See infra* note 34 and accompanying text.

The Supreme Court articulated a third approach in *Strong v. Repide*, 213 U.S. 419 (1909). In *Strong*, the director of a corporation that owned substantial tracts of land in the Philippines secretly sold some of the corporation's land to the United States. *Id.* at 432. Before the announcement of the sale, which caused the stock to triple in value, the director, acting through a third party broker to conceal his identity, bought shares of the corporation's stock from the plaintiff. *Id.* at 432-33. The Court held that the director had an affirmative duty to disclose all material facts prior to trading due to the "special facts" of the case, which included his position as director and his knowledge of the significant land sale transaction. *Id.* at 431.

For subsequent cases invoking the "special facts doctrine," see *Fox v. Cosgriff*, 66 Idaho 371, 381-82, 159 P.2d 224, 228 (1945); *Agatucci v. Corradi*, 327 Ill. App. 153, 157-58, 63 N.E.2d 630, 632 (1945); *Buckley v. Buckley*, 230 Mich. 504, 508, 202 N.W. 955, 956 (1925). *See also* *Chiarella v. United States*, 445 U.S. 222, 247 (1980) (Blackmun, J., dissenting) ("special facts" doctrine so broad it is in essence adoption of the minority rule). For a full discussion of *Chiarella*, see *infra* notes 30-35 and accompanying text.

15. 15 U.S.C. §§ 77a-77aa (1982); 15 U.S.C. §§ 78a-78kk (1982). Congress enacted the 1933 and 1934 Acts in response to proof of widespread abuses in the securities markets. *See* S. REP. NO. 1455, 73d Cong., 2d Sess. 163-220 (1934); S. REP. NO. 792, 73d Cong., 2d Sess. 7-9 (1934). *See generally* Brudney, *supra* note 13, at 330-31 (discussing evidence of securities abuses contained in the legislative history of the 1934 Act).

16. 17 C.F.R. § 240.10b-5 (1982). For the text of rule 10b-5, see *supra* note 7.

17. *See* Langevoort, *supra* note 12, at 2. Neither section 10(b) nor rule 10b-5 expressly prohibits insider trading. *See supra* notes 6 & 7. In fact, Congress regulated insider trading in only one instance. Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (1982), provides for recovery of short-term profits earned by certain insiders buying and selling the same securities within a six-month period. Because section 16(b) is designed merely to prevent desig-

an insider's duty of disclosure, courts initially interpreted its broad, anti-fraud language to include codification of the common law tort of deceit.¹⁸ Courts were uncertain, however, whether 10b-5 extended to impersonal transactions, such as those occurring on the stock exchange, where reliance is difficult to prove.¹⁹

The Securities and Exchange Commission (SEC) resolved this question in *Cady, Roberts & Co.*,²⁰ holding that rule 10b-5 prohibited a broker, who had inadvertently received inside information from a corporate director,²¹ from trading shares of the corporation on the stock exchange.²²

Concluding that the broker's actions violated rule 10b-5, notwithstanding that he was not an insider,²³ the SEC established that rule 10b-5 prohibited impersonal transactions of tippees.²⁴ The SEC estab-

nated insiders from recovering short-term profits and not to prevent fraudulent conduct, it is ineffective against most insider trading abuses. See Langevoort, *supra* note 12, at 3 n.7.

18. *E.g.*, *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa.), *modified*, 83 F. Supp. 613 (E.D. Pa. 1947); *In re Ward La France Truck Corp.*, 13 S.E.C. 373 (1943). See also Note, *Market Insiders*, *supra* note 13, at 877; Note, *It Takes a Thief*, *supra* note 13, at 102-04; Note, *Civil Liability*, *supra* note 13, at 554-56. See generally *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 437 (2d Cir. 1943) (discussion of the Securities Acts' relationship to the common law views of the duty to disclose).

19. See *infra* notes 21-26 and accompanying text.

20. 40 S.E.C. 907 (1961).

21. In *Cady, Roberts*, a director of the Curtiss-Wright corporation, believing that the information was public, tipped a broker that Curtiss-Wright's board recently voted to cut its dividend. *Id.* at 909. The broker immediately traded on the basis of this information, successfully disposing of several hundred shares of Curtiss-Wright stock before the corporation publicly announced the dividend cut and the New York Stock Exchange suspended trading. *Id.* at 909-10.

22. *Id.* at 914 (asserting that a contrary decision would be "anomalous"). See also Langevoort, *supra* note 12, at 8. The SEC also rejected an assertion that the defendant lacked a fiduciary duty because his transaction did not involve a purchase from existing shareholders, but rather sales to non-shareholders. 40 S.E.C. at 913-14 & n.23.

23. The broker was merely a tippee trading on inside information. The SEC stated, however, that traditional insiders such as corporate officers, directors, and controlling shareholders "do not exhaust the classes" of individuals subject to rule 10b-5. *Id.* at 912. See *infra* notes 42-43 and accompanying text.

24. Commentators disagree over whether there should be rules governing insider trading at all. The expansion of rule 10b-5 to encompass the regulation of insider trading on impersonal markets sparked considerable controversy. See Heller, *Chiarella, SEC Rule 14e-3 and Dirks: "Fairness" versus Economic Theory*, 37 BUS. LAW 517, 520-27 (1982); Manne, *In Defense of Insider Trading*, 44 HARV. BUS. REV. 113, 116-18 (Nov.-Dec. 1966) [hereinafter cited as Manne, *Insider Trading*]; Manne, *Insider Trading and the Law Professor*, 23 VAND. L. REV. 547, 565-76 (1970) [hereinafter cited as Manne, *Law Professor*]. See also Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309; Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801 (1980); Wu, *An*

lished a two-part test to identify those subject to liability under 10b-5 for trading on nonpublic information. First, the individual must have access to corporate information not intended to accrue to anyone's benefit.²⁵ Second, there must exist the inherent unfairness involved when such a person trades with others knowing they do not have access to the same information.²⁶

The Second Circuit further expanded the scope of rule 10b-5 in *SEC*

Economist Looks at Section 16 of the Securities Exchange Act of 1934, 68 COLUM. L. REV. 260 (1968).

25. 40 S.E.C. at 912. The SEC stated that its objective was to "identify those persons who are in a special relationship with a corporation and privy to its internal affairs. . . ." *Id.*

The "special relationship" requirement can be read broadly to imply that fraud might be established absent a fiduciary relationship on the part of the trader. The Second Circuit gave credence to such an expansive view in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), when it stated that trading on the mere "possession" of inside information was sufficient to constitute a violation of rule 10b-5. *Id.* at 848. The Supreme Court in *Chiarella v. United States*, 445 U.S. 222 (1980), overruled the "mere possession" rule, stating that there is no 10b-5 violation absent a fiduciary duty to disclose. *See infra* notes 30-35 and accompanying text.

26. 40 S.E.C. at 912. This second prong is aimed at preventing shareholder harm. The SEC stated that the insider's "relationship to his customers was such that he 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 interests ahead of his own." *Id.* at 916 n.31.

The SEC was not advocating equal information among traders. The SEC expressed concern not for the unfairness which results when parties possessing different degrees of information trade, but for that which results from one party having *access* to information which the other party could not lawfully reach prior to its public disclosure. The SEC stressed that it is inherently unfair for a person to take "advantage of [inside] information knowing it is *unavailable* to those with whom he is dealing." *Id.* (emphasis added). There is judicial support for the equal access theory; arguably its roots lie firmly in the legislative history of the securities laws. *E.g.*, *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 851-52 (2d Cir. 1968) ("[t]he 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."), *cert. denied*, 394 U.S. 976 (1969). For a comprehensive discussion of the justification for the equal access theory, see Brudney, *supra* note 13, at 339-47, 353-67.

The equal access theory should not be confused with the "equal information" theory, which requires that all investors actually have the same information before trading. Commentators suggest that regulations requiring equal information would be impossible to enforce. *See* Brudney, *supra* note 13, at 354-55 (distinguishing the equal access theory from the equal information theory). At one time the SEC appeared to support an equal information theory. *See* Faberge, Inc., 45 S.E.C. 249, 254 (1973). For commentary in support of the equal information theory, see generally W. PAINTER, *THE FEDERAL SECURITIES CODE AND CORPORATE DISCLOSURES* (1979); Kaplan, Wolf v. Weinstein: *Another Chapter on Insider Trading*, 1963 SUP. CT. REV. 273; Loss, *The Fiduciary Concept as Applied to Trading by Corporate "Insiders" in the United States*, 33 MOD. L. REV. 34 (1970); Painter, *Rule 10b-5: The Recodification Thicket*, 45 ST. JOHN'S L. REV. 699 (1971); Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425 (1967).

v. Texas Gulf Sulphur Co.,²⁷ holding that any person possessing material inside information has a duty to disclose it or refrain from trading until such information becomes public.²⁸ In predicating 10b-5 liability on the mere “possession” of material nonpublic information, *Texas Gulf Sulphur* deviated from the line of common law cases which held that there was no duty to disclose inside information outside of the corporate official-shareholder trading context.²⁹

The Supreme Court first considered the extent to which rule 10b-5 proscribed insider trading in *Chiarella v. United States*.³⁰ In *Chiarella*, the Court reversed the conviction of a printer’s employee who reaped great profits in the stock market after deducing the secret identities of corporate takeover targets from documents he was printing.³¹ The Court, citing *Cady, Roberts*, held that a duty to disclose nonpublic information prior to trading vests only in those standing in a fiduciary relationship to shareholders.³² The Court concluded that *Chiarella* incurred no duty to disclose information before trading because, unlike a corporate official who must act in accordance with his fiduciary duty to shareholders, *Chiarella* was a “complete stranger” who happened to acquire otherwise nonpublic information.³³

Although the Court in *Chiarella* narrowed the scope of 10b-5,³⁴ it

27. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

28. *Id.* at 848. Corporate officials, acting on inside information that Texas Gulf Sulphur (TGS) had struck a large ore deposit in Canada, purchased large quantities of TGS stock and call options. *Id.* at 843-47. The Second Circuit, holding that rule 10b-5 imposed a duty to disclose or abstain from trading, enjoined the officers from further trading and subsequently ordered them to return their illegally acquired profits. *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1307 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971).

29. *See supra* notes 20-24 and accompanying text. Facially, *Texas Gulf Sulphur* does not appear to go beyond *Cady, Roberts*. The SEC in *Cady, Roberts*, however, while advocating the equal access theory, did not rule on the doctrine’s applicability to a non-fiduciary. *See supra* note 26. The *Texas Gulf Sulphur* court, in contrast, explicitly stated that *anyone* possessing material nonpublic information had a duty to disclose or refrain from trading. 401 F.2d at 848.

30. 445 U.S. 222 (1980).

31. *Id.* at 224. The defendant purchased shares of the target companys’ stock before public announcement of the bids. *Id.* Once the information was public, the shares naturally increased in value, netting *Chiarella* a \$30,000 gain. *Id.* The district court convicted *Chiarella* of a criminal violation of section 10(b) of the 1934 Act and rule 10b-5. *See* 15 U.S.C. § 78ff(a) (providing for criminal penalties for willful violations of the 1934 Securities Exchange Act). The Second Circuit, relying on *Texas Gulf Sulphur*, affirmed his conviction. 558 F.2d 1358, 1373 (2d Cir. 1978).

32. 445 U.S. at 231-33. The Supreme Court flatly rejected the assertion that a duty to disclose arises absent a fiduciary duty merely because one possesses material nonpublic information. *Id.* at 233. *See infra* notes 74-75 and accompanying text.

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

34. *Chiarella*’s narrowing of rule 10b-5 in the context of insider trading parallels the Court’s

failed to address explicitly whether "tippees" of corporate insiders are among those required to disclose before trading. The Court stated, however, that a tippee had a duty to disclose if he served as "a participant after the fact in the insider's breach of a fiduciary duty."³⁵

*Dirks v. SEC*³⁶ presented an opportunity for the Supreme Court to settle finally the issue of when a corporate insider's duty to disclose extends to corporate tippees. By a six to three³⁷ vote the Court held that a tippee derivatively acquires a duty of disclosure from the fiduciary duty an insider-tipper owes corporate shareholders.³⁸ If the insider's purpose for tipping is not to secure personal gain, he does not breach his fiduciary duty *and* the tippee does not breach his derivative duty by trading.³⁹

Justice Powell, writing for the majority, began by reaffirming

restriction of the scope of 10b-5 in other areas. *Cf. Sante Fe Indus., Inc. v. Green*, 430 U.S. 642 (1977) (narrowing the coverage of the 10b-5 requirement of manipulation and deception); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (establishing a scienter requirement); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (establishing a "standing" requirement that the plaintiff must be a buyer or seller of the security in question). For a more in-depth discussion of the trend noted above, see Long, *Treble Damages for Violations of the Federal Securities Laws: A Suggested Analysis and Application of the RICO Civil Cause of Action*, 85 DICK. L. REV. 201, 201-05 (1981).

35. 445 U.S. at 230 n.12 (1980). One commentator prophesied that "in light of the emphasis in the *Chiarella* footnote on a breach of fiduciary duty by the insider, if the insider has a legitimate business purpose in communicating the information, there [is] no fraudulent misconduct punishable under rule 10b-5." Langevoort, *supra* note 12, at 27. Langevoort's prediction was correct. See *Dirks v. SEC*, 103 S. Ct. 3255 (1983). See also *infra* notes 47-50 and accompanying text.

For support, the *Chiarella* Court cited *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith*, 495 F.2d 228 (2d Cir. 1974). In *Shapiro*, Merrill Lynch, a prospective underwriter for Douglas Aircraft Company debentures, tipped several of its favored clients that Douglas Aircraft Company would soon report sharply lower earnings. *Id.* at 231-32. The tippees were able to sell their Douglas shares before the decline in earnings became public and before Douglas shares plummeted in value in response to the news. *Id.* at 232-33. The Second Circuit, citing *Texas Gulf Sulphur*, held that tippees are subject to the same duty as insider-tippers to disclose or abstain from trading. *Id.* at 237.

The *Shapiro* court grounded its decision heavily on the broad "possession" theory which the Supreme Court explicitly rejected in *Chiarella*. 445 U.S. at 231. See *supra* notes 32-33 and accompanying text. Therefore, although the Court in *Chiarella* cited *Shapiro* in reference to tippee liability, *Shapiro* is clearly weak precedent.

36. 103 S. Ct. 3255 (1983).

37. Justice Powell wrote for the majority in which Chief Justice Burger and Justices White, Rehnquist, Stevens and O'Connor joined. Justice Blackmun filed a dissenting opinion in which Justices Brennan and Marshall joined.

38. 103 S. Ct. at 3264.

39. *Id.* at 3265-66. See *infra* notes 48-52 and accompanying text.

Chiarella,⁴⁰ and rejecting the notion that tippees acquire a duty to disclose whenever they obtain inside information.⁴¹ The court cautioned, however, that tippees are not always free to trade on nonpublic information.⁴² For instance, because tippees acquire a derivative fiduciary duty from their corporate tippers,⁴³ fiduciaries and tippees cannot act *in tandem* to allow the fiduciary indirectly to achieve unlawful objectives he could not lawfully reach directly.⁴⁴ Justice Powell, citing *Chiarella*,⁴⁵ thus concluded that a tippee assumes a derivative fiduciary duty to disclose only if the insider's tip constitutes a breach of his fiduciary duty to shareholders.⁴⁶

Justice Powell then turned to a consideration of whether Secrist's tip to Dirks constituted a breach of his fiduciary duty to EFCA shareholders.⁴⁷ Citing *Cady, Roberts*, Justice Powell noted that one "purpose of the securities laws was to eliminate the use of inside information for

40. *Id.* at 3261. The Court stated:

We were explicit in *Chiarella* in saying that there can be no duty to disclose where the person who has traded on inside information 'was not the [corporation's] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.'

Id. (citations omitted). See *supra* notes 30-35 and accompanying text.

41. *Id.* at 3262. The Court reiterated its fear of imposing a general duty on the public to "forgo actions based on material, nonpublic information." *Id.* at 3261 (quoting *Chiarella v. United States*, 445 U.S. 222, 223 (1980)). One commentator suggests that the Court's fear stems from its lack of a solid theory on which to predicate such a general duty. Easterbrook, *supra* note 24, at 323.

42. 103 S. Ct. at 3263.

43. *Id.*

44. *Id.* at 3264. Justice Powell pointed to section 12 of the 1934 Act, 15 U.S.C. § 78t(b) (1982), which provides: "It shall be unlawful for any person, directly or indirectly, to do any act or thing which would be unlawful for such person to do under the provisions of this title . . . or any rule or regulation hereunder through or by means of any other person." *Id.*

45. *Chiarella v. United States*, 445 U.S. 222, 230 n.12. See *supra* notes 34-35 and accompanying text.

46. 103 S. Ct. at 3264. The Court reasoned that because a tippee's duty to corporate shareholders derives from the insider's duty, the tippee has no duty to disclose or refrain from trading in the absence of such a duty on the part of the insider. *Id.*

Justice Powell qualified this concept, asserting that "under some circumstances" professionals with a "special confidential relationship" to a corporation may have a direct fiduciary responsibility to the shareholders, and therefore, an independent duty to disclose. *Id.* at 3261 n.14. Justice Powell identified underwriters, accountants, lawyers, and consultants as persons who might fit within this category. He asserted that these professionals may incur a duty to disclose when they legitimately receive nonpublic corporate information that the corporation expected them to keep confidential. Justice Powell emphasized that under such circumstances a professional "may be treated more properly as a *tipper* than a *tippee*." *Id.* (emphasis added).

47. *Id.* at 3265.

personal advantage.”⁴⁸ He expressly rejected the notion that equal information among traders was an important factor in determining whether an insider breached his fiduciary duty.⁴⁹ Justice Powell concluded that an insider-tipper breaches his fiduciary duty when, in tipping, he secures a direct or indirect personal gain.⁵⁰ Justice Powell noted that Secrist, the tipper, tipped with the intent to expose the EFCA fraud, and not for the forbidden purpose of obtaining personal advantage.⁵¹ Absent a breach of fiduciary duty on the part of Secrist, Dirks could not breach his derivative duty.⁵²

Justice Blackmun, in dissent, accepted the majority’s articulation of the derivative duty concept,⁵³ but vigorously challenged the majority’s “improper purpose” test.⁵⁴ He asserted that Secrist, in tipping Dirks, ultimately intended to encourage Dirks’ institutional clients to sell their EFCA stock.⁵⁵ Secrist, whose fiduciary duty prevented him from directly trading on the basis of the disclosed information, thereby suc-

48. *Id.* (quoting *Cady, Roberts & Co.*, 40 S.E.C. 907, 912 n.15 (1961)). The footnote in *Cady, Roberts* that the Court cited corresponds to the SEC’s discussion of its first requirement for finding that an individual has a duty to disclose: that the insider has access to corporate information not intended to accrue to anyone’s personal benefit. *See supra* note 25 and accompanying text. The second prong of the SEC’s proposed test, which focuses on the inherent unfairness involved when such insiders trade with others knowing they are not privy to the same information, demonstrates that the SEC was as concerned with shareholder harm as with insider gain. *See supra* note 26.

49. 103 S. Ct. at 3263. In rejecting the “equal information” theory, the Court noted the method by which corporate information reaches the market. The Court explained that market analysts often meet with corporate insiders to help form judgments concerning a particular stock’s value. These judgments are then made available to the analyst’s clients in market newsletters. The Court stated that “[i]t is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation’s stockholders or the public generally.” *Id.* The Court did not discuss the less onerous and more practical requirement of equal access to information. *See supra* note 26 and accompanying text.

50. 103 S. Ct. at 3265. The Court thus established a “proper purpose” test. If the insider’s purpose for tipping is not improper, he breaches no fiduciary duty when he discloses the secret corporate information. The SEC argued that such a test enables insiders to “fabricate some ostensibly legitimate business justification for transmitting the information.” *Id.* The Court responded that the test focused on objective criteria such as whether the insider derived “pecuniary gain or a reputational benefit that will translate into future earnings.” *Id.* at 3266.

51. *Id.* at 3267-78.

52. *Id.* at 3268. The Court explained that “Dirks therefore could not have been ‘a participant after the fact in [an] insider’s breach of a fiduciary duty.’” *Id.* (quoting *Chiarella v. United States*, 445 U.S. 222, 230 n.12 (1980)). *See supra* note 35 and accompanying text.

53. 103 S. Ct. at 3270 (Blackmun, J., dissenting).

54. *Id.* at 3270-74 (Blackmun, J., dissenting).

55. *Id.* at 3268 (Blackmun, J., dissenting).

cessfully caused others to divest their interests.⁵⁶ Thus, Justice Blackmun argued, Sechrist achieved indirectly what he could not lawfully achieve directly.⁵⁷

Justice Blackmun maintained that the majority incorrectly relied on *Cady, Roberts* to characterize the insider's duty as one imposed to prevent personal gain.⁵⁸ He asserted instead that the duty is based on a "relationship of trust and confidence,"⁵⁹ giving the shareholders an assurance that the fiduciary will not take actions that will harm them.⁶⁰ Justice Blackmun contended that Sechrist's actions harmed those market participants who acquired EFCA shares,⁶¹ and further stressed that Sechrist's failure to realize personal gain did not "eradicate the shareholders' injury."⁶²

Justice Blackmun found no precedent for the "improper purpose" test⁶³ and criticized the majority for adding a "subjective limitation" to the concept of fiduciary duty.⁶⁴ Moreover, he charged the majority with adopting a policy that gave more weight to the "benefits" secured from the exposure of the Equity Funding fraud than to the *harm*

56. *Id.* at 3269 (Blackmun, J., dissenting). Justice Blackmun stated that it is undisputed that Sechrist could not directly trade on his inside information. "Unlike the printer in *Chiarella*, Sechrist stood in a fiduciary relationship with these shareholders. As the [majority stated] . . . corporate insiders have an affirmative duty of disclosure when trading with shareholders of the corporation" *Id.*

57. *Id.* at 3269-70 (Blackmun, J., dissenting). The dissent argued that according to the majority's view that tippees cannot enable a fiduciary to reach indirectly an objective he could not lawfully reach directly, *see supra* notes 42-44 and accompanying text, Dirks' actions made him "liable as a participant in the breach after the fact." *Id.* at 3270. *See supra* note 35 and accompanying text.

58. 103 S. Ct. at 3271 & n.9 (Blackmun, J., dissenting). Justice Blackmun asserted that private gain was not a requisite element of the *Cady, Roberts* conception of duty. He maintained that the prevention of pecuniary gain had nothing to do with the second prong ("inherent unfairness") of the *Cady, Roberts* test. *Id.* at 3271 n.9. *See supra* note 26 and accompanying text.

59. 103 S. Ct. at 3270 (Blackmun, J., dissenting) (citing *Chiarella v. United States*, 445 U.S. 222, 228 (1980)).

60. *Id.* (Blackmun, J., dissenting).

61. *Id.* at 3269 (Blackmun, J., dissenting). Justice Blackmun argued that Sechrist's disclosure to Dirks resulted in a shift of the inevitable, major loss due to the EFCA fraud from Dirks' clients to the unsuspecting public. *Id.*

62. *Id.* at 3271 (Blackmun, J., dissenting).

63. *Id.* at 3272 (Blackmun, J., dissenting). Justice Blackmun claimed that the majority derived its entire support for its "improper purpose test" from a footnote in *Cady, Roberts* and a single comment in a law review article. *Id.* at 3270 n.6.

64. *Id.* at 3272 (Blackmun, J., dissenting).

caused EFCA shareholders by exposure of the fraud.⁶⁵

Dirks represents yet another phase of the Supreme Court's narrowing of rule 10b-5.⁶⁶ Although the Court properly stated the derivative duty concept,⁶⁷ its formulation of the "improper purpose" test warrants critical scrutiny.⁶⁸ The Court derived its entire support for the "improper purpose" test from a footnote in *Cady, Roberts*, which asserts that a purpose of the 1934 Act was to eliminate the corporate officer's use of inside information for personal advantage.⁶⁹ The Court appears to have ignored subsequent discussion in *Cady, Roberts* identifying a legislative intent to protect the investing public.⁷⁰ The Court's new inquiry into motive adds a subjective component to rule 10b-5, grossly overcomplicating the SEC's already difficult enforcement duties.⁷¹

While the Court correctly rejected, from both a practical and legal standpoint, any need for *equal information* among traders,⁷² it failed to distinguish the fundamentally different *Cady, Roberts* concept of *equal access* to information.⁷³ An equal access requirement develops from the view that it is inherently unfair for an individual to trade on information he knows is unavailable to the general public.⁷⁴ Such a requirement would not affect a situation in which certain information is open to all investors, but only if they know the proper source.⁷⁵

65. *Id.* at 3272-73 (Blackmun, J., dissenting). Justice Blackmun characterized the majority's approach as using the end to justify the means. *Id.*

66. *See supra* note 34.

67. *See supra* notes 38 & 41-44 and accompanying texts.

68. *See supra* notes 47-52 and accompanying text.

69. *See supra* notes 48 & 58-62 and accompanying texts.

70. *See supra* notes 25-26 & 48 and accompanying texts. The SEC in *Cady, Roberts* most likely did not intend to impart the significance to its footnote that the *Dirks* majority attaches to it. If the SEC had, it certainly would have found for *Cady, Roberts & Co.* as the tip in question came from an insider who had nothing to gain from tipping. *See supra* note 21 and accompanying text.

71. The *Chiarella* test was much simpler to administer. Under *Chiarella*, the SEC only needed to establish three clear elements to find a duty to disclose and a breach thereof. The "insider" had to be a corporate fiduciary, in possession of material, nonpublic information, who failed to disclose prior to trading. *Chiarella v. United States*, 445 U.S. 222 (1980). *See supra* notes 32-33 and accompanying text. The Court's new motive inquiry requires the SEC to ascertain whether an insider is disingenuous in his assertion of legitimate business purpose. *See supra* note 50.

72. *See supra* notes 26 & 41 and accompanying texts.

73. *See supra* note 26 and accompanying text.

74. *Id.*

75. *Id.* In fact, an equal access requirement fits in well with the majority's conception of how market information reaches the public. *See supra* note 49. If analysts make their judgments available in newsletters to their clients, then technically anyone can acquire the same information if they know where to look or with whom to speak.

The Supreme Court, in applauding Dirks' role in the exposure of EFCA's massive fraud,⁷⁶ failed to give sufficient weight to the manipulative aspect of Dirks' actions.⁷⁷ Dirks clearly acted in the best interest of a few powerful clients, causing the shift of an inevitable multimillion dollar loss from certain large firms to an unsuspecting public.⁷⁸ In recognizing the importance of encouraging corporate officers to reveal evidence of corporate mismanagement to the public, the Court has paradoxically set a precedent for future manipulative activities.⁷⁹

The Court, however, deserves praise for expanding that category of individuals who have a direct fiduciary duty to a corporation.⁸⁰ The Court draws a line, albeit a fine one, between those professional "outsiders" whose "special relationship" to the corporate decisionmaking process makes them privy to inside information, and those whose relationship with the corporation makes them dependent on others to secure such data.⁸¹ In placing a direct fiduciary duty to disclose on the former group of outsiders, the Court recognized the special place such persons occupy in the corporate machine and their corresponding access to the most sensitive corporate secrets.⁸²

The clear losers of the *Dirks* decision are the SEC and the public. The Court's shift of focus from protecting the investing public to the relatively less critical matter of preventing insiders' personal gain⁸³ limits the effectiveness of rule 10b-5 as a means of preventing fraudulent conduct in connection with the purchase and sale of securities. The Court itself acknowledges that it may prove difficult to determine an insider's motive.⁸⁴ Congress should act to remedy the unacceptable advantage which *Dirks* gives to corporate insiders, their tippees, and their

76. See *supra* text accompanying notes 51-52.

77. See *supra* note 65 and accompanying text.

78. *Id.*

79. Now a tipper and a trading tippee can avoid all liability by simply "fabricating" a proper purpose. See *supra* notes 50-52 and accompanying text. The Court gave little attention to the argument that its decision provides the investing public almost no protection. 103 S. Ct. at 3267 n.27.

80. See *supra* note 46. This expansion is contrary to the limiting approach of the remainder of the opinion. See *supra* notes 40-45 and accompanying text.

81. See *supra* note 46.

82. The *Dirks* majority followed the directive pronounced in *Cady, Roberts* requiring scrutiny of the actions of those who have access to secret corporate information intended only to fulfill a corporate purpose. See *supra* note 25 and accompanying text.

83. See *supra* notes 50-52 and accompanying text.

84. 103 S. Ct. at 3266 (1983).

powerful clients at the expense of the investing public. The decision clearly opens the door for the very type of manipulative practices that Congress found to undermine confidence in the nation's securities market.⁸⁵

M.D.M.

85. *See supra* note 15.