Rule 10B-5 and the Personal Benefit Requirement: Dirks v. Securities & Exchange Commission

Paul Lansing

Cris Alan Schoon

Follow this and additional works at: http://open.mitchellhamline.edu/wmlr

Recommended Citation
Available at: http://open.mitchellhamline.edu/wmlr/vol11/iss1/1
RULE 10b-5 AND THE PERSONAL BENEFIT
REQUIREMENT: *DIRKS v. SECURITIES &
EXCHANGE COMMISSION*

PAUL LANSING†
& CRIS ALAN SCHOON‡

In order to protect investors and to prevent the control of stock prices by
corporate insiders, the prohibition of insider trading has become a funda-
mental goal of the courts and the SEC in enforcing the securities laws.
Brokers who reveal inside information to their clients may be in violation
of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.
In *Dirks v. Securities & Exchange Commission*, the Supreme Court
narrowed the scope of 10b-5 liability by establishing a new personal bene-
fit requirement. This Article examines the *Dirks* decision and the liabil-
ity of brokers who reveal inside information about corporate fraud, and
concludes that further guidance from the courts and the SEC is necessary.

I. INTRODUCTION ...................................... 2
II. HISTORY AND GOALS OF RULE 10B-5 ............ 5
III. THE LAW BEFORE *DIRKS* ......................... 11
A. Scope of Section 10(b) and Rule 10b-5 .......... 11
B. The Fiduciary Duty as a Requisite for Rule 10b-5
   Liability ........................................... 11
C. Tippee Liability .................................... 13
IV. THE FACTS AND PROCEDURAL HISTORY OF
    *DIRKS* ........................................ 15
V. THE SUPREME COURT DECISION .................... 20
A. The Majority Opinion ................................ 20
B. The Dissent ....................................... 22
VI. ANALYSIS OF *DIRKS AND THE PERSONAL
    BENEFIT REQUIREMENT* .......................... 24
A. Validity of the Decision ............................ 24
B. Examination of the Personal Benefit Requirement 28
C. Proposed Alternatives ............................. 34
VII. CONCLUSION ............................................. 37

† Associate Professor, College of Business Administration, University of Iowa. B.A.,
City University of New York, 1968; J.D., University of Illinois, 1971; Diploma in Interna-
‡ B.B.A., University of Iowa, 1981; J.D., University of Iowa, 1984.
I. INTRODUCTION

The issue has become a familiar one in the securities regulation arena: when does an actor violate the antifraud provisions of the Securities Exchange Act of 1934 by trading or inducing others to trade in the stock exchange on the basis of material inside information that has not been fully disclosed to the public? One would expect the answer to come from a simple reading of the statute or rule. Yet the courts have laced section 10(b) of the Securities Ex-

1. The antifraud provision of the Securities Exchange Act of 1934, section 10(b), is set out as amended in section 78 of title 15 of the United States Code. Section 10(b) reads in pertinent part:

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

   (b) To use or employ, in connection with the purchase or sale of any security 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.


"Inside information" has been defined as non-public 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. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc), cert. denied, 404 U.S. 1005 (1971); In re Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961); Maher v. Williston & Beane, Inc., [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,457, at 92,259 (S.D.N.Y. 1972).
change Act and its corresponding administrative provision, Rule 10b-5, with such complex and inconsistent underpinnings that an examination of the history and development of the law is required to address this issue.

The enforcement of Rule 10b-5 is intended to have a substantial impact on the behavior of insiders and brokers. Rule 10b-5 is foremost a deterrent against fraudulent and unfair trading practices. Defendants found guilty of violations of the securities laws may be subject to criminal sanctions. In the case of a broker, his license may be revoked or suspended. A private cause of action for monetary damages is also available for violations of section 10(b). Nevertheless, if Rule 10b-5 applies in a situation such as the one presented in the Supreme Court decision in Dirks v. Securities and Exchange Commission, it could inhibit or totally prohibit "in-

3. An insider has been defined as any person having "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone." Texas Gulf Sulphur, 401 F.2d at 848. An insider is usually a director or officer of the corporation. See id.; see also Cady, Roberts & Co., 40 S.E.C. at 912; infra note 30.

One commentator has argued that without Rule 10b-5 or any enforcement thereunder, more insiders would trade on their nonpublic information, thus increasing the volume of trade on the exchanges. The price of a stock will similarly increase when insiders with material, nonpublic information purchase shares of the security, even if the purchase is from stockholders who do not have such knowledge. This theory concludes that the price of stock will more accurately reflect its real value if insiders are allowed to trade on their nonpublic information. See Heller, Chiarella, SEC Rule 14e-3 and Dirks: "Fairness" versus Economic Theory, 37 Bus. Law. 517, 522 (1981-1982).

4. A broker "trades on [a client's] behalf with another broker who represents a buyer or seller." 5B A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 § 210.02 (2d ed. rev. 1984). A dealer sells a security to a client "out of [the dealer's] inventory or purchases it from [the client] for [the dealer's] own account." Id. For purposes of this Article, the word "broker" will be used to refer to both brokers and dealers.

5. The preamble of the Securities Exchange Act of 1933 provides evidence of legislative intent: "To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, to prevent frauds in the sale thereof, and for other purposes." Securities Act of 1933, Pub. L. No. 22, preamble, 48 Stat. 74, 74 (1933).

6. 15 U.S.C. § 77x (1982) (violation of 1933 Securities Act subjects offender to fine of up to $10,000, or imprisonment for up to five years, or both); 15 U.S.C. § 78ff (1982) (violation of 1934 Securities and Exchange Act subjects offender to fine of up to $500,000, or imprisonment for up to five years, or both); 15 U.S.C. § 80a-48 (1982) (violation of 1940 Investment Company Act subjects offender to fine of up to $10,000, or imprisonment for up to five years, or both); 15 U.S.C. § 80b-17 (1982) (violation of Investment Advisors Act subjects offender to fine of up to $10,000, or imprisonment for up to five years, or both).


siders" or brokers from exposing corporate criminal behavior that is brought to their attention through material nonpublic information. Applying Rule 10b-5 in such a manner would discourage brokers from ferreting out fraud and illegalities within corporations in which their clients and the public hold vital interests.

The Supreme Court used the opportunity presented in Dirks to establish and apply a new "personal benefit" requirement to Rule 10b-5 actions. After Dirks, personal benefit to an insider must be proven in order to convict or establish liability under 10b-5. The purpose of this Article is to review the goals and objectives of the federal securities laws, specifically section 10(b) and Rule 10b-5, in light of Dirks. The Article examines the Dirks decision to determine what impact the new personal benefit rule will have on the future behavior of analysts, stockbrokers, and insiders. The Article also explores what effect the new requirement may have on the Securities and Exchange Commission's (SEC) efforts to enforce the intent of the securities laws. Finally, the Article examines the merits and methods of disclosing corporate criminal activity and how the Dirks personal benefit requirement may frustrate attempts to halt this activity.

10. See supra note 2 and accompanying text (discussion of "material" information).
11. See In re Dirks [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,812, at 83,950 (1981). A broker would be discouraged from disclosing fraud under the SEC's Dirks decision. The SEC outcome could subject brokers who expose fraudulent or deceptive practices to criminal penalties and private civil actions. To avoid these penalties, brokers would abstain from disclosing inside information about fraudulent corporate activity. Brokers would not search out and expose fraudulent schemes in their beginning stages for fear of 10b-5 liability. The fraud would go undetected, injuring more people than if it had been initially disclosed and stopped. See infra notes 188-93 and accompanying text.
13. Id. at 3266.
14. The recent release of a Ralph Nader study on insiders who must file with the SEC when they trade, and the subsequent violations of federal securities laws which Nader uncovered, are evidence of the timeliness of this Article. The Nader study of 20 blue-chip corporations found that 74 of their directors in certain years had not filed required reports of any stock trades with the SEC, even though there apparently had been changes in the size of their holdings. The SEC had not filed court charges against any of the executives for violating the filing requirement, Nader argued. Hudson, Many Directors Ignore SEC Rule on Stock Trades, Nader Study Concludes, Wall St. J., Dec. 5, 1983, at 36, col. 3. This Article analyzes several of the problems raised by the Nader report: apparent disconcern or ambiguity in regulating insider trading; inconsistency in the enforcement of the laws; and lack of SEC resources to do anything about many violations. The Wall Street Journal noted one SEC official who claimed that the agency did not have enough workers to do anything about even those obvious reporting violations that their computers flagged. Id.; see also infra note 160.
II. HISTORY AND GOALS OF RULE 10b-5

Section 10(b) was adopted as part of the Securities Exchange Act of 1934. The Act provides for the regulation of securities exchanges and over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices. The 1934 Act embraces a fundamental purpose to substitute the philosophy of full disclosure for the philosophy of caveat emptor in the exchange of securities in the public marketplace. The legislative history and language of section 10(b) demonstrate that Congress intended the statute to act as a broad prohibition against securities fraud.

The 1934 Act and its progeny were designed to eliminate certain abuses in the securities industry that contributed to the stock market crash of 1929 and the Depression of the 1930's. Congress en-

---


16. Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972). One of the purposes of the Act was "to purge the securities exchanges of those practices which have prevented them from fulfilling their primary function of furnishing open markets for securities where supply and demand may freely meet at prices uninfluenced by manipulation or control." Charnay, 537 F.2d at 347 (quoting S. REP. NO. 1455, 73d Cong., 2d Sess. 81 (1934)).

17. Charnay, 537 F.2d at 347-48. In Superintendent of Ins. v. Bankers Life & Casualty, 404 U.S. 6 (1971), the Court discussed the broad application of section 10(b). The Court stated that since practices "constantly vary and where practices legitimate for some purposes may be turned to illegitimate and fraudulent means, broad discretionery powers in the regulatory agency have been found practically essential . . . . Section 10(b) must be read flexibly, not technically and restrictively." Id. at 12 (quoting H.R. REP. NO. 1383, 73d Cong., 2d Sess. 7 (1934)).


For a general analysis of 1920's market manipulation problems and subsequent Con-
acted the Securities Exchange Act to eliminate the idea that the use of inside information for personal advantage was a "normal emolument of corporate office." Hence, Rule 10b-5 was devised by the SEC in 1942 under the authority of section 10(b).

Rule 10b-5 was adopted in order to close "a loophole in the protection against fraud . . . by prohibiting individuals or companies from buying securities if they engage in fraud in their purchases." Section 10(b) and Rule 10b-5 thus form the core of federal securities fraud law under the Securities Exchange Act of 1934.

In addition to the aims espoused by the legislative and administrative branches, the judiciary has also broadly interpreted the goals of 10b-5. Courts have enumerated a number of policy objectives when examining activities alleged to infringe Rule 10b-5: to maintain free and honest securities markets; to supply equal access to information; to assure equal bargaining strength; to progressional Acts, see Douglas & Bates, The Federal Securities Act of 1933, 43 YALE L.J. 171 (1933); Loomis, The Securities Exchange Act of 1934 and the Investment Advisors Act of 1940, 28 GEO. WASH. L. REV. 214 (1959); Shulman, Civil Liability and the Securities Act, 43 YALE L.J. 227 (1933).


23. See, e.g., Chiarella, 588 F.2d at 1362; Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236 (2d Cir. 1974); Smallwood, 489 F.2d at 600 (investors should have equal access; citing Texas Gulf Sulphur, 401 F.2d 833); Crane Co. v. Westinghouse Air

http://open.mitchellhamline.edu/wmlr/vol11/iss1/1
Brake Co., 419 F.2d 787, 796 (2d Cir. 1969), cert. denied, 400 U.S. 822 (1970) (investors should have equal access; quoting Texas Gulf Sulphur, 401 F.2d 833); Texas Gulf Sulphur, 401 F.2d at 848, 851-52 (persons with inside information may not take advantage of it if they know it is unavailable to the investing public; 10(b)-5 is implementation of Congress' purpose that all investors should have equal access to rewards of trading); Birdman v. Electro-Catheter Corp., 352 F. Supp. 1271, 1274 (E.D. Pa. 1973); In re Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961) (insider cannot use inside information to his advantage knowing the public does not have access to it); see also Herpich, 430 F.2d at 806 (investors should have information to make intelligent decisions); Chris-Craft Indus., Inc. v. Bangor Punta Corp., 426 F.2d 569, 580 (2d Cir. 1970) (Lombard, C.J., dissenting) (investors should have equal access; citing Texas Gulf Sulphur, 401 F.2d 833; securities laws are designed to provide equal access); Kahan, 424 F.2d at 173 (citing policy supported in Texas Gulf Sulphur, 401 F.2d 833); Schoenbaum, 405 F.2d at 212 (Section 10(b) intended to enable investors to make proper appraisal of value of securities). But see Bloomenthal, From Bloomandal to Schoenbaum: The Exchange Act and Self-Agrandizement, 15 N.Y.L.F. 332, 351 n.79 (1969) (criticizing the majority in Texas Gulf Sulphur, 401 F.2d 833, for not considering why Congress failed to provide an express remedy if it intended to place investors on an equal footing). See generally 5 JACOBS, supra note 4, at § 6.03 (discussion of equal access to information as a policy).

24. See, e.g., Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 101 (10th Cir.), cert. denied, 404 U.S. 1004 (1971), cert. denied, 405 U.S. 918 (1972) (federal courts have ceased to look upon 10(b)-5 in narrow context of seller protection and have begun to see in it greater purpose of equalization of bargaining position); Herpich, 430 F.2d at 806 (Congress intended to give investors a reasonable opportunity to make intelligent decisions); Mader v. Armel, 402 F.2d 158, 162 (6th Cir. 1968) (duty of disclosure is an attempt to provide some degree of equalization of bargaining position; quoting Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951) with approval), cert. denied, 394 U.S. 930 (1969); Schoenbaum, 405 F.2d at 212 (purpose of § 10(b) is to enable investors to make proper appraisal of value of securities); Rogen v. Ilikon Corp., 361 F.2d 260, 268 (1st Cir. 1966) (Rule 10b-5 attempts to equalize bargaining power between the individual and the corporation); List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.) (purpose of 10b-5 is to put both buyer and seller in an equal bargaining position), aff'd 227 F. Supp. 906, 911 (S.D.N.Y. 1964) (equalize bargaining position; quoting Speed, 99 F. Supp. at 828-29), cert. denied, 382 U.S. 811 (1965); Kennedy v. Tallant, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,779, at 90,820 (S.D. Ga. 1976) (equalization of bargaining position is "[a] common thread running through the fabric of the various securities cases"); Coyne v. MSL Indus., Inc.,[1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,451, at 99,284 (N.D. Ill. 1976) (one purpose of Rule is "to equalize the bargaining position of corporate insiders and uninformed minority shareholders"); Jackson v. Bache & Co., 381 F. Supp. 71, 85 (N.D. Cal. 1974) ("10b-5 has been utilized to inject some degree of bargaining equality into the purchase and sale of securities"); Neidermeyer v. Niedermeyer, [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,123, at 94,500 (D. Ore. 1973) (purpose of disclosure is to equalize bargaining positions of parties); Baumel v. Rosen, 283 F. Supp. 128, 139 (D. Md. 1968) (equalize bargaining position; quoting Speed, 99 F. Supp. at 828-29), modified on other grounds, 412 F.2d 571 (4th Cir. 1969), cert. denied, 396 U.S. 1037 (1970); Kohler v. Kohler Co., 208 F. Supp. 808, 820 (E.D. Wis. 1962) (equalize bargaining position; quoting Speed, 99 F. Supp. at 829), aff'd, 319 F.2d 634 (7th Cir. 1963) (quoting Speed, 99 F. Supp. at 828-29); Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (D. Del. 1951) (duty of disclosure is an attempt to provide some degree of equalization of bargaining position); Case Note, Securities Regulation—Rule 10b-5 Concepts of Materiality and Duty of Disclosure Expanded, 37 FORDHAM L. REV. 483, 489 n.37 (1969) (equalization of bargaining position is policy which cases state most clearly); cf. 5 JACOBS, supra note 4, at § 6.04 (policy of equalization of bargaining positions has begun to give way in recent years to other concepts).
mote full disclosure;\textsuperscript{25} to protect investors;\textsuperscript{26} to assure fairness;\textsuperscript{27} to

\textsuperscript{25} See, e.g., Arber v. Essex Wire Corp., 490 F.2d 414, 418 (6th Cir.) (underlying\textsuperscript{10b-5} is Congressional intent that full disclosure will help to insure fair dealing in insider
transactions), cert. denied, 419 U.S. 830 (1974); Popkin v. Bishop, 464 F.2d 714, 719-20 (2d Cir. 1972) (10(b) and \textsuperscript{10b-5} are designed principally to impose duty to disclose); \textit{In re Penn Cent. Secs. Litig.}, 357 F. Supp. 869, 876 (E.D. Pa. 1973) (10(b) and \textsuperscript{10b-5} were designed to insure full disclosure), aff'd, 494 F.2d 528 (3d Cir. 1974); Abramson v. Nytronics Inc., 312 F. Supp. 519, 526 (S.D.N.Y. 1970) ("10(b)-5 is basically a disclosure provision"); Comment, \textit{Federal Securities Regulation—Insider Trading—Stock Options Under SEC Rule \textsuperscript{10b-5}}, 54 IOWA L. REV. 635, 641-44 (1969) (distinct public interest in having information disclosed); Note, \textit{Accountants' Liability for Nondisclosure of After-Acquired Information: Strict Liability Under Rule \textsuperscript{10b-5}?}, 22 Rutgers L. REV. 554, 559 (1968) (full disclosure is goal of Exchange Act and consequently of \textsuperscript{10b-5}); Note, \textit{Purchaser's Duty to Disclose Under Securities and Exchange Commission Rule \textsuperscript{X-10B-5}}, 40 MINN. L. REV. 62, 71 (1955) (purpose of Rule \textsuperscript{10b-5} is to equalize bargaining positions by encouraging disclosure); Note, Section 29(a) of the Securities Exchange Act: A 'Legislative Chaperon' for Rule \textsuperscript{10b-5}, 63 Nw. U. L. REV. 499, 502 n.22 (1968) (disclosure now a primary goal of \textsuperscript{10b-5}, although not a main objective when promulgated); Note, \textit{Texas Gulf Sulphur: Expanding Concepts of Corporate Disclosure Under SEC Rule \textsuperscript{10b-5}}, 43 St. John's L. REV. 425, 430 (1969) (\textsuperscript{10b-5} has become a disclosure rule to satisfy policy of equalization of bargaining position although disclosure may not have been an original objective of the Rule); Recent Decisions, \textit{Corporations—Nine Of Eleven Officers, Directors, And Employees Of Defendant Corporation Held Not To Have Violated Section 10(b) And Rule \textsuperscript{10b-5} Of The Securities Exchange Act Of 1934 Since They Were Not In Possession Of Material Undisclosed Information When They Traded In Texas Gulf Sulphur Securities}, 55 ILL. B.J. 688, 703 (1967) (\textsuperscript{10b-5} intended to achieve prompt and complete disclosure of material facts); Note, \textit{Securities Exchange Act of 1934—Defense of Unclean Hands Prevents Recovery Under Section 10(b) And Rule \textsuperscript{10b-5} by a Plaintiff Who Has Himself Traded on Inside Information}, 44 TUL. L. REV. 618, 619 (1970) (fundamental purpose of Act and Rule \textsuperscript{10b-5} to substitute philosophy of full disclosure for philosophy of caveat emptor); \textit{cf. Ruder, Texas Gulf Sulphur—The Second Round: Priesty and State of Mind in Rule 10b-5 Purchase and Sale Cases}, 63 NW. U. L. REV. 423, 443 (1968) (granting that disclosure is desirable but questioning whether liability should arise out of failure to disclose); Note, \textit{Texas Gulf Sulphur: Expanding Concepts of Corporate Disclosure Under SEC Rule \textsuperscript{10b-5}}, 43 St. John's L. REV. 655, 667-68 (1969) (imposition of an affirmative duty of continuous disclosure is "a distinct possibility," but "one that will certainly be unwelcomed in the business community"). See generally JACOBS, supra note 4, at § 6.05 (discussion of disclosure as a policy).

\textsuperscript{26} See, e.g., Woodward v. Metro Bank, 522 F.2d 84, 91 (5th Cir. 1975) (primary purpose is investor protection); McClure v. First Nat'l Bank, 497 F.2d 490, 495 (5th Cir. 1974) (fundamental purpose is investor protection), cert. denied, 420 U.S. 930 (1975); Sargent v. Genesco, Inc., 492 F.2d 750, 760 (5th Cir. 1974) (investor protection is a fundamental goal); \textit{Merrill Lynch}, 495 F.2d at 235 (investor protection is a fundamental policy); International Controls Corp. v. Vesco, 490 F.2d 1334, 1346 (2d Cir. 1974) (intended to protect creditors and stockholders), cert. denied, 417 U.S. 932 (1974); \textit{Manor Drug Stores}, 492 F.2d at 140; James v. Gerber Prods. Co., 483 F.2d 944, 948 (6th Cir. 1973) (investor protection is a principal purpose); Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 363 (2d Cir.) (major Congressional policy), cert. denied, 414 U.S. 910 (1973); Travis v. Anthes Imperial, Ltd., 473 F.2d 515, 522 (8th Cir. 1973); Haberman v. Murchison, 468 F.2d 1305, 1312 (2d Cir. 1972) (protect uninfomed outsiders); Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 890 (2d Cir. 1972); \textit{Hooper}, 282 F.2d at 202 (10b-5 can rest on either protection of investors or public interest); Branham v. Material Sys. Corp., 354 F. Supp. 1048, 1054 n.2 (S.D. Fla. 1973) (protection of investors is of primary importance); Gerstle v. Gamble Skogmo, Inc., 298 F. Supp. 66, 95-96 (E.D.N.Y. 1969) (purpose to protect public), modified and aff'd, 478 F.2d 1281 (2d Cir. 1973); Moore v. Greatamerica Corp.,
build investor confidence,²⁸ and to deter violations while compen-


27. See, e.g., Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1050 (7th Cir.) (ultimate goal of securities regulations is to achieve fundamental fairness), cert. denied, 434 U.S. 875 (1977); Charmey, 537 F.2d at 349 (means to prevent inequitable and unfair practices); Woodward, 522 F.2d at 91, 93 n.20 (promote climate of fair dealing); Merrill Lynch, 495 F.2d at 235, 240 (purpose to prevent inequitable and unfair practices and to ensure fair dealing); Arbor, 490 F.2d at 418 (ensure fair dealing); James, 483 F.2d at 948 (protect traders from those who deal unfairly with them); Piper Aircraft, 480 F.2d at 357 (insure maintenance of fair and honest markets); Haberman, 468 F.2d at 1312; Radiation Dynamics, 464 F.2d at 890-91 (goal of fundamental fairness); Herpich, 430 F.2d at 801, 806, 808 (designed to prevent inequitable and unfair practices in securities markets and foster climate of fair dealing); Crane Co., 419 F.2d at 793, 796 (referring to unfair practices by party in a takeover fight and holding that fair dealing is a purpose of Exchange Act); Mader, 402 F.2d at 162 (quoting Speed, 99 F. Supp. 808); Texas Gulf Sulphur, 401 F.2d at 847-48, 860 (Exchange Act intended to prevent inequitable and unfair practices by insiders and ensure fairness in securities transactions); Fox v. Prudent Resources Trust, 382 F. Supp. 81, 86, 88 n.4, 89 (E.D. Pa. 1974) (basic purpose is to safeguard investors from devices adverse to fair dealing); Garner v. Pearson, 374 F. Supp. 591, 595 (M.D. Fla. 1974) (prevents inequitable and unfair practices and ensures fairness and honesty); Cant v. A.G. Becker & Co., Inc., 374 F. Supp. 36, 46 (N.D. Ill. 1974) (10b-5 intended to bar use of devices alien to climate of fair dealing); Bryan v. Brock & Blevins Co., 343 F. Supp. 1062, 1069 (N.D. Ga. 1972) (promote climate of fair dealing), aff'd, 490 F.2d 563 (5th Cir.), cert. denied, 419 U.S. 844 (1974); Baunet, 283 F. Supp. at 139 (prevent unfair advantage; quoting Speed, 99 F. Supp. at 829, with approval); Bound Brook Water Co. v. Jaffe, [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,243, at 97,141 (D.N.J. 1966) (disclosure laws enacted to promote fair dealing); Brennan v. Midwestern United Life Ins. Co., 259 F. Supp. 673, 681 (N.D. Ind. 1966) (promote fair play; quoting Kohler, 319 F.2d at 642, with approval), cert. denied, 397 U.S. 989 (1970); List, 227 F. Supp. at 911 (prevent unfair advantage; quoting Speed, 99 F. Supp. 929, with approval); Kohler, 208 F. Supp. at 820 (prevent unfair advantage; quoting Speed, 99 F. Supp. at 829, with approval), aff'd, 319 F.2d at 638 (prevent unfair advantage; quoting Speed, 99 F. Supp. at 828, with approval); Speed, 99 F. Supp. at 828-29 (insider’s duty of disclosure necessary to prevent taking unfair advantage of stockholders).

²⁸. See, e.g., Sargent, 492 F.2d at 760 (10b-5 policy to instill confidence in securities market); Carroll v. First Nat'l Bank, 413 F.2d 353, 357 (7th Cir. 1969) (victimization of brokers may impair public confidence in integrity and stability of market), cert. denied, 396 U.S. 1003 (1970); Symposium, Insider Trading in Stocks, 21 Bus. Law. 1009, 1010 (1966) (investor confidence essential to promote private investment in public companies); Comment, Insider Trading on the Open Market: Nondisclosure and Texas Gulf Sulphur, 42 S. Cal. L. Rev. 309, 314 (1969) (foundation of any securities market is investor confidence). See generally 5 JACOBS, supra note 4, at § 6.08 (discussion of encouraging investor confidence as policy of 10b-5).
sating victims. 29

The purchase and sale of securities is in need of regulation for the protection of investors. A major concern arises when information intended only for a corporate purpose, and not for personal benefit, is used to the advantage of particular insiders. 30 Section 10(b) was designed to create an efficient market system and to instill trust in the public that market prices were not controlled by insiders. When large numbers of individuals and businesses survive on market transactions, the unwary public's fate should not be unfairly determined by allowing a person in possession of material nonpublic information to trade in the same market. 31


30. Insiders have traditionally included officers, directors, and controlling stockholders of corporations. Cady, Roberts & Co., 40 S.E.C. at 912. This list of insiders is not all-inclusive, however. Id. The SEC has taken the position that the purposes served by the insider trading proscriptions are just as compelling where the corporate informant who divulges confidential information is not of the highest rank, but "in a special relationship with a company and privy to its internal affairs." In re Dirks, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,812, at 83,948 (1981) (quoting Cady, Roberts & Co., 40 S.E.C. at 912), rev'd, 103 S. Ct. 3255 (1983).

31. To this end one of the major purposes of the securities acts is the prevention of fraud, manipulation or deception in connection with securities transactions. Cady, Roberts & Co., 40 S.E.C. at 910. Some commentators, however, argue that insiders should be able to trade on the basis of nonpublic information if it would be lawfully available to others. See Brudney, Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws, 93 HARV. L. REV. 322, 359-65 (cited with approval in Dirks, 103 S. Ct. at 3266). Another commentator suggests that if the insider has a legitimate purpose in communicating the information, then there should be no liability under Rule 10b-5 for such communication because there is no fraudulent conduct. Langevoort, supra note 2, at 47 (cited in Dirks, 681 F.2d at 839 n.18). Others contend that economic considerations do not justify restrictions on insider trading because such trading increases the information flow to the market and thereby improves market efficiency. Heller, supra note 3, at 522 n.10.
III. THE LAW BEFORE DIRKS

Before analyzing the conclusions of the Dirks decision, it is helpful to thoroughly examine the principal issues that the courts and the SEC focused on prior to Dirks.

A. Scope of Section 10(b) and Rule 10b-5

The Supreme Court has construed section 10(b) to bar the use of deceptive devices in the purchase or sale of securities. Although section 10(b) has been described as a catchall provision in the federal securities laws, the Court has made clear that "what it catches must be fraud." There is a violation of Rule 10b-5 whenever an insider fraudulently trades on material nonpublic information for personal gain. Fraud includes "all acts, omissions and concealments that involve a breach of legal or equitable duty, trust or confidence, justly reposed, and are injurious to another, or by which an undue and unconscionable advantage is taken of another." Rule 10b-5 does not encompass valid trading on rumors or analysis of publicly available information.

B. The Fiduciary Duty as a Requisite for Rule 10b-5 Liability

Before 1980, the justification for finding a violation of Rule 10b-5 was premised on the idea that the rule "is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access

32. Superintendent of Ins., 404 U.S. at 12.
33. Texas Gulf Sulphur, 401 F.2d at 848 n.9; see also supra note 21 and accompanying text.
34. Chiarella v. United States, 445 U.S. 222, 235 (1980). Only conduct involving manipulation or deception is reached by Section 10(b) or Rule 10b-5. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 474-77 (1977). In the following cases courts have found a particular action one of "deception": Affiliated Ute Citizens, 406 U.S. 128 (misstatements of material fact used by bank employees in position of market maker to acquire stock at less than fair value); Superintendent of Ins., 404 U.S. at 9 (seller of bonds was tricked into believing that it would receive the proceeds); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975) (scheme of market manipulation and merger on unfair terms, one element was misrepresentation); Shell v. Hensley, 430 F.2d 819 (5th Cir. 1970) (derivative suit alleging that corporate officers used misleading proxy materials and other reports to deceive stockholders); Santa Fe Indus., 430 U.S. at 475 n.15.
36. Capital Gains Research, 375 U.S. at 194. The Supreme Court, however, has recognized that even the potential for fraudulent abuse is enough to cause a purchase or sale of a security to fall within the Securities Exchange Act. Id. at 200.
37. See Heller, supra note 3, at 528-29.
to material information." In 1980, however, the Court held in *Chiarella v. United States* that liability under Rule 10b-5 could not simply turn on whether the defendant knew that other people trading in the securities market did not have access to the same information. *Chiarella* involved an employee of a financial printer who set type for documents to be used in connection with tender offers. Because of his work, Chiarella was able to learn which companies were about to be the targets of tender offers at above-market prices. He would buy stock in the target companies before the offers were announced and sell afterwards at a profit. Chiarella was charged with violating a number of the securities laws, including section 10(b) and Rule 10b-5. In reversing Chiarella's conviction, the Supreme Court limited the scope of liability by holding that an actor can violate Rule 10b-5 only if he is under a legal duty to disclose the material information prior to consummation of the securities transaction. If the defendant is neither an insider nor a fiduciary, there is no obligation to reveal material facts.

The *Chiarella* Court initiated its probe into the legal obligation requirement by examining two principal elements of duty considered by the SEC in *In re Cady, Roberts & Co.* In *Cady, Roberts & Co.*, the SEC held that an insider holding material undisclosed information is required to either abstain from trading or adequately disclose the information prior to such trading. This 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." The *Chiarella* Court refined the principles enunciated in *Cady, Roberts & Co.* by resolving that the duty to disclose would arise only where one party had information that another party was "entitled to know because of a fiduciary or other similar relation of trust and confidence between them." After determining that Chiarella

---

38. *Texas Gulf Sulphur*, 401 F.2d at 848.
40. *Id.* at 222-24.
41. *Id.* at 232-35.
42. *Id.* at 229.
43. *Id.* at 226-29 (citing *Cady, Roberts & Co.*, 40 S.E.C. 907).
46. *Id.* at 228; see *Pitt, Chiarella Court: Limits on Novel 10b-5 Actions*, Legal Times of Wash., Mar. 31, 1980, at 12, col. 1; *Wang, supra* note 15, at 1270-71.

http://open.mitchellhamline.edu/wmlr/vol11/iss1/1
was neither an agent for the sellers of the target companies' securities, a fiduciary, nor a person in whom the sellers had placed their trust and confidence, the Court held that Chiarella was not bound by the disclosure duty required by Rule 10b-5.47

C. Tippee Liability

In cases prior to Chiarella, courts and the SEC focused on the tippee as the primary or coequal wrongdoer.48 A tippee is one who receives confidential corporate information from an insider.49 An insider is one who obtains inside information in his business capacity and has a legitimate business reason for knowing the information.50 Unlike an insider, a tippee neither obtains inside information in a business capacity nor has a legitimate business reason for knowing it.51 Although insiders and tippees obtain their information differently, both are subject to the same duties under Rule 10b-5. To be held liable, a tippee must know or have reason to know that his inside information was obtained improperly, by selective revelation or otherwise.52

Cady, Roberts & Co. was a tippee case.53 A partner of Cady, Rob-

---

47. 445 U.S. at 231-37.
48. Langevoort, supra note 2, at 25. See generally 5B Jacobs, supra note 4, at §§ 162-168 (discussion of tipping).
49. Langevoort, supra note 2, at 24.
50. See 5A Jacobs, supra note 4, at § 66.02(a) (discussing insiders).
51. Id.
52. In re Investors Management Co., Inc., 44 S.E.C. 633, 644 (1971); accord Barnett, Neither a Tipper Nor a Tippee Be, 8 Hous. L. Rev. 278, 285, 290-91 (1970) (unequal access); Bromberg, The Law of Corporate Information, Fin. Analysts J. Mar.-Apr. 1969, at 26, 27 (discussing Texas Gulf Sulphur, 401 F.2d 833; concluding that to violate 10b-5, tippee must have knowledge that information comes from a company source); Painter, Rule 10b-5: The Recodification Thicket, 45 St. John’s L. Rev. 699, 708 (1971) (actual or constructive knowledge that information came from a company source or from an insider); Weeks & McCormick, Broker-Dealer Disclosure of Corporate Inside Information, 18 Clev. St. L. Rev. 549, 560 (1969) (tippee must know, actually or constructively, that information came from a company source); Comment, Investors Management Company and Rule 10b-5 — The Tippee at Bay, 72 Colum. L. Rev. 545, 550, 555-59 (1972) (constructive knowledge required for insiders; actual knowledge required for tippees and presumptions); Note, Securities Law — Rule 10b-5 — Persons Not Corporate Insiders Censured for Use of Non-Public Information, 40 Fordham L. Rev. 985, 994 (discussing SEC's scienter requirement established in Investors Management Co., 44 S.E.C. at 644); see also Jacobs, supra note 4, at § 66.02(a) n.32; infra notes 59, 92.
53. 40 S.E.C. 907.
erts & Co., a registered brokerage firm, was informed of a dividend reduction by an associate of the firm who was also a director of the issuer of the security. The partner knew that the information had not been released to the public, yet he executed orders for the sale of shares of the securities for his discretionary accounts. The SEC held that these actions violated Rule 10b-5. The Commission decreed that buyers who purchase stock from persons having the responsibilities of an insider should have the same protection provided by disclosure as their sellers did. Therefore, liability must be extended to the tippee to protect both buyers and sellers.

The Chiarella Court incorporated the element of legal duty into tippee liability. The Court stated that tippees of corporate insiders who trade on the inside information violate section 10(b) "because they have a duty not to profit from the use of inside information that they know . . . or should know came from a corporate insider." The SEC must prove that the tippee knew that the tipper had a special relationship to the issuer, and breached his duty to keep the information secret. The Chiarella Court reasoned that a tippee's duty "arises from his role as a participant after the fact in the insider's breach of a fiduciary duty."

54. Id. at 908.
55. Id. at 908-09, 912.
56. Id. at 911.
57. Id. at 912.
58. Id. at 913.
59. 445 U.S. at 230 n.12. Negligence has now been rejected as a standard for private damage actions. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) (plaintiff must prove scienter in private damage action; negligence is insufficient in 10b-5 private damage suits); see also supra note 52 and accompanying text. Something more than having "reason to know" may therefore be required. The court in Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264 (S.D.N.Y. 1972), aff'd, 495 F.2d 228 (2d Cir. 1974), used the "reason to know" test, although it rejected negligence as a standard of care for the defendants. Id. at 273, 279. The court of appeals affirmed the district court in Shapiro, holding that the tippees violated 10b-5 because they "knew or should have known of the confidential source." 495 F.2d 228, 238 (2d Cir. 1974).

If the "know or reason to know" approach is used, the question arises whether the insider or tippee should be used as a standard to determine if he had reason to know (a subjective approach) or whether a fictional reasonable man should be employed (an objective approach). See Fisher, 266 F. Supp. at 188 (promoting subjective standard). See generally 5A JACOBS, supra note 4, at § 68 (discussion of standard of conduct, scienter, negligence and due diligence); 5B JACOBS, supra note 4, at § 167, 167 n.15 (discussion of liability of tippers).

60. See Investors Management Co., 44 S.E.C. at 651 (Smith, Comm'r, concurring).
61. 445 U.S. at 230 n.12.
IV. THE FACTS AND PROCEDURAL HISTORY OF DIRKS

Raymond L. Dirks was a securities broker who specialized in insurance stock at a New York brokerage firm. Dirks dealt exclusively with institutional clients that he knew had invested or might be interested in investing in insurance company stocks. Dirks was apparently highly respected and well known within the investment community for his knowledge of insurance companies and his willingness to go beyond mere financial data in evaluating investments.

On March 6, 1973, Dirks received a telephone call from Ronald Secrist, a former employee of Equity Funding Corporation of America (Equity Funding). Equity Funding was a substantially diversified company, engaged primarily in selling life insurance. Secrist made a number of detailed allegations about Equity Funding. He reported foremost that the company had created at least 40,000 fictitious life insurance policies to inflate its sales figures. The fictitious policies represented approximately one-third of Equity Funding's outstanding life insurance business.

Secrist informed Dirks that the regulatory agencies had failed to act on similar charges made by other Equity Funding employees.

---


64. Id.

65. "[Equity Funding] conducted its operations through a number of subsidiaries, which included several life insurance companies, broker-dealers, investment advisors and a savings and loan association." Id. ¶ 82,812, at 83,941 n.4.

66. 681 F.2d at 829-30. Secrist mainly reported that one of Security Funding's subsidiaries had created false insurance policies and records to inflate sales figures. Secrist also alleged that the company was selling partnerships in nonexistent real estate; that its top officers had Mafia connections which they used to threaten the lives of employees who objected to the fabrications; and that the accounting firm of Haskins & Sells had dropped the Equity Funding account out of disagreement with the company's business practices. Id. Through one informant, Dirks later learned that Secrist's allegations about Haskins & Sells were untrue. The accounting firm had lost Equity Funding's business to a competitor and would have been glad to get it back. Id. at 829.

67. [1981 Transfer Binder] FED. SEC. L. REP. ¶ 82,812, at 83,941. "To carry out its scheme, . . . [Equity Funding] created supporting files, medical records and death certificates for non-existent policyholders, bribed and intimidated some of its auditors and state examiners, and falsified its financial records to show the receipt and disposition of non-existent premiums." Id. (footnote omitted).

68. Id. ¶ 82,812, at 83,942.

69. Id.
He encouraged Dirks to verify the fraud and publicly disclose it. Secrist provided Dirks with names of present and former Equity Funding employees who would corroborate his charges. Secrist also gave Dirks permission to disclose his allegations to the Wall Street Journal.70

Believing that Secrist was not merely a vindictive former employee, Dirks decided to investigate Secrist's accusations.71 First, Dirks examined public data regarding Equity Funding's insurance sales and found nothing that would confirm or refute that the company was fabricating policies.72 He then contacted others in the investment community to determine if they knew anything that could prove or disprove the rumors.73 This search was generally fruitless. Dirks also telephoned Equity Funding's chairperson, who denied that there was any fraud and invited Dirks to visit the company's headquarters in Los Angeles.74 Finally, on March 19, Dirks flew to Los Angeles to visit with other former Equity Funding employees.75 Several sources confirmed the allegations about inflated and phony insurance sales. Another admitted that he had been involved in altering the company's insurance-in-force figures.76

While in Los Angeles, Dirks met with Equity Funding officers who continued to deny that there was anything amiss in the company.77 Dirks also frequently visited with William Blundell, the Wall Street Journal's Los Angeles bureau chief. Dirks was unsuccessful at convincing Blundell to write a story on the allegations of fraud at Equity Funding.78 Yet on March 26, Blundell contacted the SEC's Los Angeles office and repeated what Dirks had been telling him. The SEC took no immediate action.79

Meanwhile, beginning on March 12, Dirks relayed Secrist's alle-

71. 681 F.2d at 830.
72. Id.
73. Id.
74. Id.
75. Id.
76. Dirks obtained the names of these sources from Secrist and Patrick Hopper, a former vice president of Equity Funding at the time Dirks met with him. It was Hopper who suggested to Secrist that he tell his story to Dirks after Secrist lost his job. Id.
77. Id.
78. Blundell was afraid that publishing such damaging rumors supported only by hearsay from former employees might be libelous. Id. at 831-32.
79. Id. at 832.
gations against Equity Funding to a number of his clients and other investors and brokers who had an interest in Equity Funding.\textsuperscript{80} Several of his listeners subsequently sold large blocks of Equity Funding stock.\textsuperscript{81} In less than two weeks from the time Dirks began investigating and spreading word of Secrist's allegations, the trading price of Equity Funding shares fell from twenty-six dollars to less than fifteen dollars.\textsuperscript{82} The SEC finally halted trading in the stock on March 28.\textsuperscript{83}

On April 2, the SEC filed a complaint against Equity Funding and a front-page story written by Blundell was published in the Wall Street Journal.\textsuperscript{84} Equity Funding immediately went into receivership.\textsuperscript{85} Dirks, although neither he nor his firm ever owned or traded any Equity Funding stock, became the object of an SEC disciplinary proceeding.\textsuperscript{86}

After applying the well-established rules from \textit{Cady, Roberts \& Co.}\textsuperscript{87} and \textit{Chiarella}\textsuperscript{88} to non-trading security brokers who tip material nonpublic securities information,\textsuperscript{89} the SEC concluded that

\begin{itemize}
\item \textsuperscript{80} This was at least a week before Dirks flew to Los Angeles to confirm Secrist's allegations with other sources. [1981 Transfer Binder] FED. SEC. L. REP. ¶ 82,812, at 83,942.
\item Dirks reported the full allegations to Boston Company Institutional Investors, Inc., which on March 15 and 16 sold approximately $1.2 million of Equity securities. Boston Company directed business to Delafield Childs, the brokerage where Dirks worked, that generated approximately $25,000 in commissions. 103 S. Ct. at 3269 & n.4. On March 26, Dirks informed the investment advisor firm John Bristol & Co., Inc. that if he were in Bristol's position, he would sell the stock that its clients held in Equity Funding securities. Bristol immediately sold all of its Equity Funding holdings for over $8 million. [1981 Transfer Binder] FED. SEC. L. REP. ¶ 82,812, at 83,944.
\item 681 F.2d at 832.
\item [1981 Transfer Binder] FED. SEC. L. REP. ¶ 82,812, at 83,944.
\item Blundell, \textit{A Scandal Unfolds: Some Assets Missing, Insurance Called Bogus at Equity Funding Life}, Wall St. J., Apr. 2, 1973, at 1, col. 6, 14, col. 5.
\item 103 S. Ct. at 3269.
\item [1981 Transfer Binder] FED. SEC. L. REP. ¶ 82,812, at 83,939.
\item 40 S.E.C. 907, 910-17 (1961) (tippees have same duty as insiders to abstain or disclose material, nonpublic information). \textit{See generally supra} notes 43-61 (discussing \textit{Cady, Roberts \& Co.} and tippee liability).
\item 445 U.S. at 225-30 (insiders and tippees violate federal securities law when they hold a fiduciary duty to the shareholders and trade on material, nonpublic information without first disclosing it). \textit{See generally supra} notes 39-61 (discussing \textit{Chiarella} and tippee liability).
\item [1981 Transfer Binder] FED. SEC. L. REP. ¶ 82,812, at 83,945. The Commission admitted that a security analyst brings inherent value to the entire market. "[M]arket efficiency in pricing is significantly enhanced by such initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors." \textit{Id}. Nevertheless, the SEC emphasized the distinction between its long-accepted practice of allowing analysts to investigate immaterial, nonpublic inside information to enhance their competitive advantage, and a \textit{Dirks} situation where the original accusations from the in-
\end{itemize}
Raymond Dirks willfully aided and abetted violations of section 10(b) and Rule 10b-5. The Commission determined that Dirks knew that the information he obtained was confidential and non-public. In addition, the Commission found that Dirks knew or should have known by discussing the information with certain investment advisors that trading would probably result from his disclosure. Only after ruling that Dirks violated the law did the

sider were simply confirmed by the other inside sources. *Id.* at 83,947. The SEC believed that under these circumstances, its decision would not discourage analysts from engaging in the legitimate and desirable function of seeking out corporate information. *Id.* at 83,950. The Commission stated that it did "not seek in any way to chill the investigation of rumors concerning a particular company." *Id.*

90. *See* 681 F.2d at 844 (discussion of aiding and abetting principles in conjunction with Rule 10b-5). The SEC also ruled that Dirks violated section 17(a) of the Securities Act of 1933 because the securities transaction at issue was a sale. [1981 Transfer Binder] *FED. SEC. L. REP.* ¶ 82,812, at 83,945 n.20, 83,950. 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 mails, directly or indirectly —

1. to employ any device, scheme, or artifice to defraud, or
2. to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
3. to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a) (1982). *But see* Heller, *supra* note 3, at 552 (suggesting "[t]he conclusion that Dirks was an 'aider and abettor' must be seriously questioned after the decision in Chiarella"). Heller quotes former SEC general counsel Harvey Pitt: "Thus, Chiarella certainly suggests that in the absence of some affirmative and preexisting relationship between an alleged aider and abettor and those who are allegedly injured by the aider and abettor's silence or inaction, Rule 10b-5 liability simply may not exist." *Id.* at 552 (quoting Pitt, *supra* note 46, at 22, col. 4) (emphasis in Heller original).

91. [1981 Transfer Binder] *FED. SEC. L. REP.* ¶ 82,812, at 83,948-49. The SEC addressed five major issues in *Dirks.* *Id.* ¶ 82,812, at 83,945-50. First, the Commission ruled that the information Dirks disseminated was material because there was a "substantial likelihood that a reasonable shareholder would consider it important in deciding how to [act] . . . ." *Id.* at 83,946 (citing TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)). The Commission also held that the information Dirks received was inside information. A leak by a top official was not required. It was sufficient that Secrist was "in a special relationship with . . . [Equity Funding] and privy to its internal affairs." *Id.* ¶ 82,812, at 83,948 (citing *Cady, Roberts & Co.,* 40 S.E.C. at 912). The SEC then determined that Dirks' experience and his investigation of Equity Funding led to the reasonable conclusion that he knew the information was not generally available. *Id.* ¶ 82,812, at 83,948-49. The Commission then concluded that due to Dirks' experience, he had reason to know that trading would result from his disclosure. *Id.* ¶ 82,812, at 83,949. Finally, the SEC determined that Dirks acted with a conscious intent to invoke trading by disseminating the material, nonpublic information. *Id.* ¶ 83,949-50 (citing *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 193 n.12 (1976)).

92. *See id.* ¶ 82,812, at 83,949. In order for a defendant to be liable under Rule 10b-5 he must act with scienter or intent. Scienter is a mental state embracing an intent to deceive, manipulate, or defraud. *Ernst & Ernst,* 425 U.S. at 193 & n.12. It is not enough
SEC acknowledge the important role he had played in bringing the fraud to light and reduce his sixty-day suspension, imposed by the administrative law judge, to censure. 93

The District of Columbia Circuit Court of Appeals affirmed the SEC's judgment, 94 stating that security advisors associated with registered brokers must respect the disclose-or-refrain obligations of their corporate sources. 95 Reasoning that obligations of corporate fiduciaries pass to all those to whom they disclose their information before it has been disseminated to the public at large, 96 the court concluded that Dirks inherited his informants' disclose-or-refrain obligation. 97 A breach by insiders was not necessary to make their tippees answerable for acts that would have constituted a breach had they been committed by the insiders. 98

---

94. 681 F.2d 824 (D.C. Cir. 1982).
95. Id. at 837; see also supra note 44 and accompanying text (discussing the abstain-or-discard rule).
97. 681 F.2d at 839. The court of appeals announced that Dirks also had obligations to the SEC and the public independent of any obligations he derived from Secrist's duties. Id. at 840. The court stated that Rule 10b-5 should operate in conjunction with the ethical duty implied by the other provisions of the securities laws to forbid brokers, and those who obtain information from them, from trading in unsound or fraudulent securities without first disclosing the material information they possess. Id. at 842.
98. Id. at 839 n.16.
V. THE SUPREME COURT DECISION

A. The Majority Opinion

Confronted with the issue whether Dirks violated the antifraud provisions of the federal securities laws, the Supreme Court, by a six to three margin, reversed the court of appeals and found Dirks not guilty on all charges.\(^9\) Justice Powell, in the majority opinion, first discussed three notions that different adjudicative bodies had found to be requisites for a Rule 10b-5 violation: 1) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose; 2) a duty to disclose arising from the existence of a fiduciary relationship; and 3) manipulation or deception.\(^10\) The Court reiterated that "a duty to disclose arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market."\(^11\) In applying the rule to the situation at hand, Justice Powell noted that to impose a duty to disclose or abstain solely because a person knowingly received material non-public information from an insider and traded on it could have an inhibiting influence on the role of market advisors.\(^12\)

As he focused on Dirks' potential liability as a tippee, Justice Powell recognized the need for restrictions on some tippee trading.\(^13\) He stated that some tippees must assume an insider's duty to the shareholders when inside information has been made available to them improperly.\(^14\) Therefore, to determine whether a tippee is under an obligation to disclose or abstain, it is necessary to determine whether the insider's tip constituted a breach of the insider's fiduciary duty.\(^15\) In essence, a tippee's duty is derived from a breach of the tipper's fiduciary duty.

The Court stressed that not all disclosures of confidential corporate information would violate the duty insiders owe to sharehold-

\(^10\) Id. at 3260-61.
\(^11\) Id. at 3263 (quoting from Chiarella v. United States, 445 U.S. 222, 232-33 n.14 (1980)).
\(^12\) Id. The SEC itself recognized that market analysts are necessary to the preservation of a healthy market. Id.; In re Dirks, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,812, at 83,945 (1981).
\(^13\) The Court cited 15 U.S.C. § 78t(b) for the proposition that it is unlawful to do indirectly by means of any other person any act made unlawful by the federal securities laws. 103 S. Ct. at 3263.
\(^14\) Id. at 3264.
\(^15\) Id. at 3265.
Whether disclosure is a breach of duty depends on the purpose of the disclosure. Justice Powell declared that a purpose of the securities laws was to eliminate the use of inside information for personal gain. Based on this premise, the Court devised the personal benefit requirement. The majority pronounced, "The test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach."

The SEC argued that if liability was not imposed regardless of whether information was initially disclosed for a proper purpose, parties might sidestep insider trading liability by fabricating business justifications for transmitting information. Justice Powell responded, "We think the SEC is unduly concerned." The Court held that to determine whether a disclosure is fraudulent, courts must first examine "whether there has been a breach of duty by the insider." Courts could resolve this issue by focusing on an objective determination of whether the insider directly or indirectly benefitted from the disclosure. The Court advised that factors such as monetary or reputational gains should be considered. Only if the insider's personal benefit was established would a tippee inherit a duty to disclose or abstain.

The SEC argued that Dirks violated Rule 10b-5 either in the capacity of an insider or as a tippee. In response to this argument, the majority first determined that Dirks was not an insider since he had no pre-existing duty to Equity Funding's shareholders and took no action that induced the shareholders or officers of Eq-

106. Id.
107. Id.
108. Id.
109. Id. The Court cited Walton v. Morgan Stanley & Co., 623 F.2d 796 (2d Cir. 1980), as an example of a case turning on a determination that the disclosure did not impose any fiduciary duties on the recipient of the inside information. 103 S. Ct. at 3265 n.22.
110. Id.
111. Id.
112. Id. at 3266.
113. Id. Contra id. at 3270 (Blackmun J., dissenting) (asserting that the majority's personal benefit requirement imposes a new, subjective limitation on the scope of the duty owed by insiders to shareholders).
114. Id. at 3266.
115. Id.
116. Id. at 3262, 3266.
uity Funding to repose trust in him. Justice Powell then asserted that neither Secrist nor the other Equity Funding employees violated their duty to the corporation’s shareholders. The tippers received neither monetary nor personal benefit for revealing Equity Funding’s secrets. They did not intend to make a gift of valuable information to Dirks, nor to deceive or defraud anyone with the disclosed information. The Court concluded that in the absence of a breach of duty to shareholders by the insiders, there was no derivative breach by Dirks. Therefore, Dirks was not liable as a tippee for any alleged violations of Rule 10b-5.

B. The Dissent

Writing for the dissent, Justice Blackmun reproached the majority for the Dirks ruling and previous decisions that frustrated the Congressional intent behind the securities laws. The dissent argued that Congress intended the securities laws to be interpreted flexibly to protect investors and to regulate deceptive practices detrimental to their interests. The majority’s new personal benefit requirement, however, impeded the goals of 10b-5 by imposing a “special motivational requirement on the fiduciary duty doctrine.”

Except for the personal benefit requirement, Justice Blackmun followed and accepted much of the majority’s legal analysis. The dissent reasoned that Secrist stood in a fiduciary relationship with the shareholders and that corporate insiders have a duty to disclose or abstain from trading. Both opinions acknowledged that Secrist could not do through others what he was prohibited from doing personally. The dissent interpreted Secrist’s exploits to fall within this latter prohibition: Secrist intentionally used Dirks as a conduit to injure Equity Funding shareholders to whom Secrist owed a duty to disclose. The dissent concluded that, ac-

117. Id. at 3267.
118. Id. at 3267 n.27.
119. See id. at 3268 (Blackmun J., dissenting).
120. Id.
121. Id. at 3268 n.1 (Blackmun, J., dissenting) (quoting S. REP. NO. 792, 73d Cong., 2d Sess. 18 (1934) and referring inter alia to Chiarella).
122. Id. at 3268 (Blackmun, J., dissenting).
123. Id. at 3269 (Blackmun, J., dissenting).
124. Compare id. at 3269 (Blackmun, J., dissenting) with id. at 3260.
125. Compare id. at 3270 (Blackmun, J., dissenting) with id. at 3263. See also Mosser v. Darrow, 341 U.S. 267, 272 (1951).
126. 103 S. Ct. at 3270 (Blackmun, J., dissenting).
according to the majority’s view of tippee liability without the personal benefit requirement, Dirks’ knowledge of Secrist’s breach made him liable as a participant in the breach.

The dissent strongly opposed the majority’s conclusion that personal gain is required for 10b-5 liability. Justice Blackmun argued that whether the corporate insider benefitted from the transaction does not affect the shareholder’s position. The shareholder loses regardless of the insider’s motivation.

Justice Blackmun also disagreed in principle with the Court’s requirement of an improper motive. He noted the misplaced emphasis of the majority’s “new, subjective limitation on the scope of the duty owed by insiders to shareholders,” stating that the Court had confused one of the evils the securities laws were intended to prevent with the nature of the insider trading duty itself. Justice Blackmun emphasized that the second element of the Cady, Roberts & Co. obligation to abstain-or-disclose is “the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.” Justice Blackmun indicated that this second element identified the harm that the duty to disclose was designed to protect against. Enrichment of the insider is not part of the nature of the duty. It is only one of the evils the duty aims to prevent.

Justice Blackmun urged that the disclosure duty was aimed not at

127. Id. at 3270 & n.5 (Blackmun, J., dissenting). Both the majority and the dissent cited the rule espoused in In re Investors Management Co., 44 S.E.C. 633, 641 (1971). 103 S. Ct. at 3264 n.19, 3270 n.5 (Blackmun, J., dissenting). The SEC in Investors Management Co. held that one factor of tippee liability was that the “tippee knew or had reason to know that [the information] was non-public and had been obtained improperly by selective revelation or otherwise.” 44 S.E.C. at 641; see also supra notes 103-05 and accompanying text (discussion of majority’s use of tippee liability rule).

128. Justice Blackmun interpreted the Court’s opinion to impose liability on tippees when the tippee “knows or has reason to know that the information is material and non-public and was obtained through a breach of a duty by selective revelation or otherwise.” Id. at 3270 n.5 (Blackmun, J., dissenting); see Investors Management Co., 44 S.E.C. at 641; supra note 125.

129. 103 S. Ct. at 3268 (Blackmun, J., dissenting); see also Langevoort, supra note 2, at 2 n.5, 28 n.111.

130. 103 S. Ct. at 3271 (Blackmun, J., dissenting).

131. Id.

132. Id. at 3270 (Blackmun, J., dissenting).

133. Id. at 3271 n.9 (Blackmun, J., dissenting).

134. 40 S.E.C. 907 (1961); see supra notes 44-45 and accompanying text.

135. 103 S. Ct. at 3270 n.8 (Blackmun, J., dissenting) (quoting Cady, Roberts & Co., 40 S.E.C. at 912).

136. Id. at 3271 n.9 (Blackmun, J., dissenting).
the insider's personal gain, but at the misuse of nonpublic information and its subsequent effect on shareholders. 137

In support of its conclusion that personal gain is not an element of the breach of duty, the dissent compared *Dirks* to the Court's holding in *Mosser v. Darrow*. 138 In *Mosser*, a reorganization trustee was held liable for the graft of two employees he had hired to provide services for the trust even though the trustee received no personal gain. 139 The *Mosser* Court noted that although the trustee's intentions were selfless, 140 his motives were irrelevant. 141 The *Dirks* dissent concluded, "*Mosser* demonstrates . . . [that] the breach consists in taking action disadvantageous to the person to whom one owes a duty." 142 Thus, by ignoring the harm done to Equity Funding shareholders and imposing a personal benefit requirement, the majority's ruling conflicted with *Mosser*. 143

The dissent recognized that Secrist and Dirks played substantial roles in exposing the Equity Funding fraud. 144 It also admitted that the SEC had not provided much practical guidance on the procedures necessary to meet the duty to abstain or disclose. 145 The dissent determined, however, that the means Secrist chose were not laudable and that Dirks and his clients should not have profited from the information they obtained from Secrist. 146 The dissent concluded that, as a citizen, Dirks had at least an ethical obligation to report the information to the proper authorities before trading or disclosing such information to clients. 147

VI. ANALYSIS OF *DIRKS* AND THE PERSONAL BENEFIT REQUIREMENT

A. Validity of the Decision

The results achieved in *Dirks* are commendable for a number of reasons. Primarily, the *Dirks* decision is backed by precedent and

---

137. *Id.* at 3271 (Blackmun, J., dissenting).
138. 341 U.S. 267 (1951); *Dirks*, 103 S. Ct. at 3271-72 (Blackmun, J., dissenting).
139. 341 U.S. at 275. Mosser had allowed the employees to trade in the subsidiary's securities. The employees subsequently turned their inside positions into substantial profits at the expense of the trust and holders of the companies' securities. *Id.* at 269-70.
140. *Id.* at 275.
141. *Id.* at 271-72.
142. 103 S. Ct. at 3272 (Blackmun, J., dissenting).
143. *Id.*
144. *Id.* at 3273 (Blackmun, J., dissenting).
145. *Id.*
146. *Id.*
147. *Id.*
the realities of the securities exchange market. Throughout the opinion, the Dirks Court followed the directives established in its earlier decisions. The Court followed Chiarella by examining whether Dirks had a fiduciary duty to the stockholders of Equity Funding.\textsuperscript{148} The Court also followed precedent and Congressional intent by holding that fraud must be present to establish 10b-5 liability.\textsuperscript{149}

By imposing the personal benefit requirement, the Court upheld prior decisions, recognized the aims of 10b-5, and accepted the "win-lose" reality of the securities market. The focal point of Congressional intent and judicial interpretation of section 10b-5 is on fraudulent practice and unfair personal benefit to the insider—not the loss to an unsuccessful investor. In addition, the Dirks decision acknowledges the vulnerable position of brokers, investors, and insiders by refusing to impose liability for failure to disclose where the SEC has failed to promulgate guidelines for disclosure.

The Dirks majority explicitly confirmed the Chiarella Court's holding\textsuperscript{150} that there is no duty to disclose where a person who has traded on inside information is not a fiduciary or a person in whom traders of securities had placed their trust and confidence.\textsuperscript{151} If the Dirks Court had not required a fiduciary relationship before imposing 10b-5 liability, it would have departed radically from the established doctrine that a duty arises from a specific relationship between two parties. The Court could not go as far as to impose a duty on everyone who trades in securities to refrain from trading when they receive material nonpublic information.\textsuperscript{152} The Chiarella Court stated that a broad duty between all participants in market transactions to forego actions based on material nonpublic information should not be imposed absent some explicit evidence of Congressional intent.\textsuperscript{153} In Chiarella, the Court determined that no evidence of a broad duty emerged from the language or legislative history of section 10(b), nor had Congress or the SEC ever adopted a parity-of-information rule.\textsuperscript{154} Dirks follows Chiarella and an inference from Congress, ruling that

\textsuperscript{148} Id. at 3261-63; see Chiarella v. United States, 445 U.S. 222, 235 (1980).

\textsuperscript{149} 103 S. Ct. at 3261 (citing Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473 (1977)).

\textsuperscript{150} Chiarella, 445 U.S. at 235.

\textsuperscript{151} 103 S. Ct. at 3261.

\textsuperscript{152} Id.

\textsuperscript{153} 445 U.S at 234-35.

\textsuperscript{154} Id.
a fiduciary relationship must be identified before further scrutiny of fraudulent trading practices under Rule 10b-5 is undertaken.

The Court’s decision in *Dirks* is also in accordance with Congress’ intent that the securities provisions prohibit only “those manipulative and deceptive practices which have been demonstrated to fulfill no useful function.” The *Dirks* decision recognizes, consistent with this Congressional mandate and the Court’s earlier decisions, that there must be fraud to constitute a violation of Rule 10b-5. Dirks’ actions were not fraudulent. Rather, they served to expose fraud on the part of Equity Funding. The SEC believed that Dirks’ efforts in bringing Equity Funding’s massive fraud to light, including reporting the allegations to Equity Funding’s auditors and a *Wall Street Journal* reporter, were commendable enough to be grounds to reduce a sixty-day suspension to a mere imposition of censure. The court of appeals shared the view that thanks largely to Dirks, one of the most infamous frauds in recent memory was uncovered and exposed. Unquestionably, Secrist and Dirks achieved legitimate objectives by revealing a major fraud in a short span of time while the SEC repeatedly missed opportunities to investigate Equity Funding.

The new personal benefit requirement is mandated by prior judicial interpretation and the realities of the exchange market. The *Dirks* Court cited the standard “identified by the SEC itself in

155. S. REP. NO. 792, 73d Cong., 2d Sess. 6 (1934); see also Chiarella, 445 U.S. at 241 (Burger, C.J., dissenting) (quoting from S. REP. NO. 792, 73d Cong., 2d Sess. 6 (1934)).
156. *Chiarella*, 445 U.S. at 235; see also *Santa Fe Indus.*, 430 U.S. at 472; Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976).
157. 103 S. Ct. at 3261; see also Superintendent of Ins. v. Bankers Life and Casualty Co., 404 U.S. 6, 12 (1971).
158. *In re Dirks*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,812, 83,950 (1981); see also supra note 93 and accompanying text.
160. Id. at 832 n.6. The SEC had a history of failing to act promptly in the Equity Funding case. In 1971, the SEC was approached by an Equity Funding employee who reported questionable accounting practices at Equity Funding. The SEC performed a cursory investigation and took no further action. After Secrist’s charges were relayed to the California Insurance Department, a California official expressed an interest in conducting a full inspection of Equity Funding and asked for help from the SEC. The SEC staff attorney stated that similar allegations had been made about the company before by disgruntled employees. He recommended “delaying any type of inspection of the Equity Funding operations until next year when more personnel are available.” Id.; cf. [1981 Transfer Binder] FED. SEC. L. REP. ¶ 82,812, at 83,944 n.18 (SEC claimed that full parameters of the Equity Funding fraud were not revealed until after Dirks had disseminated the information). For other examples of the SEC failing to enforce securities laws, see Hudson, supra note 14, at 36, col. 3.
Cady, Roberts & Co.: a purpose of the securities laws was to eliminate 'use of inside information for personal advantage.' Section 10(b) guarantees that corporate insiders will not benefit personally through fraudulent use of material nonpublic information. The statute focuses on the benefit to the insider, rather than the loss to the investor. Thus the language of the statute commands that sensibility replace pity in the minds of courts when market "losers" bring charges of 10b-5 violations. As market values fluctuate and investors act on inevitably incomplete or incorrect information, there are always "winners" and "losers." There were indeed some "losers" as a result of Secrist's and Dirks' disclosures, but those who "lost" were not necessarily defrauded.

The dissenters in Dirks, analogizing its facts to those in Mosser v. Darrow, argued that the personal gain requirement conflicted with precedent and was not an element of Rule 10b-5. Although the reorganization trustee in Mosser received no personal gain, he was held liable for the graft of two employees he had hired to provide services for the trust. The dissent's effort to reach the same result in Dirks as in Mosser fails for several reasons. There was no similarity in the responsibilities owed by the defendants to the injured parties in each case. Secrist, not Dirks, most closely mirrored the position of the defendant-trustee in Mosser; yet the SEC never brought charges against Secrist. Furthermore, the Mosser trustee owed the highest fiduciary duty to the trust and beneficiaries, while Dirks had no fiduciary relationship with Equity Funding or any of the purchasers of the company's securities. The Court in Mosser did not have to reach the question of

161. 103 S. Ct. at 3265 (quoting Cady, Roberts & Co., 40 S.E.C. at 912 n.15). The Court also cited Brudney, supra note 31, in support of its personal benefit requirement. 103 S. Ct. at 3266. But see supra note 113; infra note 165 and accompanying text (noting dissent's claim that the requirement is unprecedented).
162. See 103 S. Ct. at 3265; Chiarella, 445 U.S. at 230.
163. 103 S. Ct. at 3267 n.27. Although the dissent was disturbed that all shareholders lost in some respect since the price of Equity Funding shares dropped from $26 to $15 during the time that Dirks investigated Equity Funding and informed clients of his findings, the majority reiterated that there may be no clear causal connection between inside trading and outsiders' losses. Id.
164. 341 U.S. 267 (1951); see supra notes 138-43 and accompanying text.
165. Id. at 3271-72 (Blackmun, J., dissenting).
166. 341 U.S. at 275. Mosser had allowed the employees to continue to trade in the subsidiaries' securities. The employees subsequently turned their inside positions into substantial profits at the expense of the trust and holders of the company's securities. Id. at 269-70.
167. Id. at 271.
168. 103 S. Ct. at 3266-67.
the insider's "personal gain" because the trustee's breach of duty was self-evident.

A final reason for satisfaction with the outcome in Dirks is that Dirks had no definitive guidance from the law regarding how, or to whom, he was to disclose the evidence of Equity Funding's fraud without the threat of reprisal from the SEC. The dissent acknowledged that while persons with inside information are instructed not to trade on that information unless they disclose, the SEC has failed to advise individuals how to disclose. The Commission requires that information become public, but there is no regulation that gives notice as to when that requirement is satisfied. Until adequate standards are established by which an individual can reasonably determine whether information has become public or not, individuals in a Dirks-type dilemma should be immune from Rule 10b-5 liability.

The Dirks decision is praiseworthy in general because it helps to clarify some uncertainty surrounding 10b-5 liability. By following precedent, construing Congressional language and recognizing the realities of the exchange market and the role of the SEC, the Court provides insight on how brokers, investors and insiders should conduct their business.

B. Examination of the Personal Benefit Requirement

The law of the land with regard to Rule 10b-5, as stated by the majority in Dirks, is "whether the insider personally will benefit, directly or indirectly, from his disclosure." It is clear that when an insider, for example, a chief executive officer, director, or employee of a corporation, buys or sells stock on material nonpublic information in his own name and personally benefits, he violates Rule 10b-5. Based on the idea of derivative liability, if an investor

169. Id. at 3273 (Blackmun, J., dissenting).
170. Id. at 3265 (emphasis added).
171. Three situations that facially may appear to invoke the Dirks doctrine include, first, one in which a corporation, by choice of its directors or chief executive officer, withholds material information from the public for a period of time. If the news were negative, the corporate action would encourage the stock price to remain artificially high. If the news were positive, the price would remain artificially low. In either instance, the failure to immediately publicize the corporate news may personally benefit particular insiders or shareholders. Second, in order to capitalize on certain tax code provisions by holding stocks for more than one year, an insider with the power to do so may be tempted to withhold corporate news for the number of days required to meet the tax law requisites. Third, an insider might consider withholding significant corporate information until he is in a better financial position to take advantage of the news once made public. Since Rule
knowingly trades on material nonpublic inside information obtained from a broker, and the broker is deemed to be an insider and has received a commission from the transaction, the Dirks personal benefit requirement is also satisfied and both the investor and the broker could be held liable for a violation of 10b-5. If a broker is found to hold no fiduciary duty, he cannot be held to the strict disclosure requirements of insiders unless he derives some liability from his tipper. If the tipper does not receive personal gain, however, derivative liability cannot be imposed on the broker.

One explanation for the Court's holding in Dirks is that the Court simply wanted to encourage exposure of fraudulent corporate behavior. In order to sanction Dirks' action, the Court created the personal benefit requirement, found Secrist had not personally benefitted, and determined that Dirks was not an insider. The Dirks decision rewards the efforts of brokers who are not insiders and who expose fraudulent activity by limiting the derivative liability of broker-tippees. Without proof of personal benefit to the insider-tipper, the SEC cannot impose liability on the broker-tippee for disseminating information unless the broker-tippee is deemed an insider.

The Dirks Court may have foreseen instances of brokers dispensing inside information solely for personal gain and without any intent to expose corporate fraud, and assumed that the broker in those circumstances could easily be judged an insider. Nevertheless, a court may seldom be able to justify categorizing a broker as an insider. Therefore, the Dirks decision and its personal benefit requirement could effectively terminate the SEC's use of 10b-5 as a viable mechanism to police securities fraud and insider trading where brokers are directly involved. After Dirks, if a broker is not considered an insider and the broker transmits inside information to investors, the broker should not fear 10b-5 liability so long as the insider-tipper of the broker does not personally benefit. If the SEC is to utilize Rule 10b-5 in regulating insiders who do not buy

10b-5 only prohibits trading on material, nonpublic information, however, this type of corporate activity would not be cause for SEC investigation under the guise of Rule 10b-5 so long as the insiders did not trade shares while the information was withheld.

172. The Supreme Court ruled that Dirks was not an insider or trader, so whether he personally benefitted from the alleged receipt of commissions was irrelevant to the issue of 10b-5 liability. 103 S. Ct. at 3267.

173. See generally supra notes 155-60 and accompanying text.

174. Brokers should not be considered insiders if they do not possess information that others are entitled to know because of a fiduciary or other similar relation of trust and confidence between them. See supra note 46 and accompanying text.
or sell stock, but rather transfer information to others so they can
do what the insiders were prohibited from doing, then the SEC
must rely on a broad interpretation of personal benefit. 175

Rule 10b-5 liability will be severely restricted unless personal
benefit is defined in terms other than receipt of a pecuniary gain or
a reputational benefit that will translate into future earnings. 176
Often there is no immediate return on a favor done by one for
another. If and when a favor is ever recovered, it may be very
difficult to quantify or value the returned favor and to ascertain
for which favor it is in return.

For example, suppose an insider relays material nonpublic infor-
mation to a popular, successful major college football coach. The
insider’s intentions may be that in the future a couple of fifty-
yardline seats will become available to him or that he will occa-
sionally be seen with the coach at lunch. Or suppose an insider’s
act of releasing inside information to particular individuals en-
ables the insider to develop an otherwise unobtainable level of es-
tee or power among the group of tippees. These not uncommon
situations suggest that unless a broad definition of personal benefit
is accepted, Rule 10b-5 will be unenforceable where insiders cir-
cumvent the law by taking their “profits” in non-monetary ways.

The Dirks Court declared that the personal benefit requirement
may be satisfied if the insider receives a reputational benefit from
his disclosure. 177 Nevertheless, measuring this type of benefit will
be difficult because there will typically be little, if any, tangible
evidence to establish actual receipt of a reputational benefit.
Given the difficulty of proving reputational gain, the SEC’s solu-
tion may be to classify all insider “benefits” that cannot be recog-
nized monetarily into the catchall category of “gifts.” 178 The Dirks
Court acknowledged the “gift” classification in dicta, stating that
“[t]he elements of fiduciary duty and exploitation of nonpublic in-
formation also exist when an insider makes a gift of confidential
information to a trading relative or friend. The tip and trade re-

175. Cf. infra notes 177-80 and accompanying text.
176. Cf. 103 S. Ct. at 3266 (majority’s mention of reputational benefit).
177. 103 S. Ct. at 3266.
178. Id. The Dirks majority emphasized that the elements of fiduciary duty and ex-
ploration of nonpublic information also exist when an insider makes a gift of confidential
information to a trading relative or friend. The “reputational benefit” or “gift” approach
to Rule 10b-5 liability should not be considered an inferior mode of enforcement. The
Dirks Court specifically included and elaborated on “reputational benefit” as one of the
objective criteria courts should focus on when determining whether there has been a
breach of duty by an insider. Id.
semble trading by the insider himself followed by a gift of profits to the recipient." The Dirks Court explained that one of the reasons the insiders were not found to have personally benefited from their actions was because their purpose was not to make a gift of valuable information to the tippees. If the Supreme Court intended the intangible and unquantifiable reward received from making a gift to satisfy the personal benefit requirement, then the requirement may not be a hurdle in sustaining a 10b-5 liability claim. Given that an insider has conveyed material nonpublic information to an investor-tippee, it would be a rare occasion when the SEC could not establish that, if nothing more, the insider-tippee received some kind of emotional benefit from making the "gift" and witnessing the tippee prosper. If the intent of Rule 10b-5—to instill trust in the public that market prices are not controlled by insiders nor are insiders using information that was intended only for a corporate purpose to their advantage—is to be fulfilled, then utilizing the "gift" theory to prove personal benefit may be the easiest way to enforce Rule 10b-5.

The gift theory may be the only way to enforce Rule 10b-5 with its personal benefit requirement when an insider-shareholder releases inside information to a friend. The tippee-friend certainly benefits if he immediately buys or sells upon receipt of the information and takes advantage of the subsequent price change that reflects the reaction of non-tippee investors upon hearing the news. As long as the insider himself did not buy or sell stock before the information became public, he has not profited in any financial sense by tipping off his friend. For the SEC, the issue now posed is whether courts will accept the argument that a gift is a personal benefit to the giver when he receives no physical, monetary, or economic gain in return.

In its development of the personal benefit requirement, the Supreme Court failed to explicitly discuss "how much" personal benefit must be received by an insider to satisfy the requirement. Should a de minimus amount of gain or emotional enjoyment be sufficient, or must the personal benefit significantly enlarge the insider’s pocketbook? This issue must be addressed by the courts in the near future to determine the extent to which the new personal benefit requirement may be satisfied.

179. Id.
180. Id. at 3268; see supra note 118 and accompanying text.
181. See supra note 28 and accompanying text.
benefit requirement will shield brokers from 10b-5 liability. If the liberal “gift” theory is applied to brokers who disburse material nonpublic information obtained from insiders, the personal benefit requirement will provide little protection from liability. If courts require a significant amount of benefit to the insider, brokers might rarely be held liable for 10b-5 violations. Until this issue is resolved, brokers cannot safely predict whether their actions may violate 10b-5. The Dirks decision provides some policy insight on how future courts should interpret the personal benefit requirement.

The policy basis of Dirks is two-fold. First, the decision in Dirks was most likely result-oriented.182 Future courts may lend deaf ears to moderate juggling of personal gains and instead balance interests in order to reach a “proper” result. Second, the Dirks decision reaffirms the popular notion that brokers play a vital and commendable role in the securities exchanges and markets.183 Courts may seek to promote this role in future decisions.

In Dirks, a policy decision was made in favor of exposing fraud and preventing further injury rather than punishing for the harm done to securities purchasers.184 Where a greater harm will obviously result without immediate disclosure, balancing the good of extinguishing that threat against those injured in the process seems advisable. In addition, since the law prohibits fraudulent corporate conduct and does not encourage its concealment, a balancing approach is appealing if it prevents section 10(b) and Rule 10b-5 from being misused to legitimize concealment of corporate fraud.

The SEC in Dirks would have preferred the result in Cady, Roberts & Co., where the defendant was held to have violated Rule 10b-5.185 Cady, Roberts & Co., however, involved premature trading on nonpublic, but licit, information.186 Dirks involved a different

---

182. See generally Simonett, The Use of the Term “Result-Oriented” to Characterize Appellate Decisions, 10 WM. MITCHELL L. REV. 187 (1984) “The term seems to suggest that a court is result-oriented when it proceeds to do what it wants to do; that it reasons backward from a desired result without regard for the merits, logic, established law, or sound policy applicable to the case.” Id. at 192.

183. See supra note 89.

184. See 103 S. Ct. at 3267-68, 3268 n.27.

185. 40 S.E.C. at 917; see supra note 87 and accompanying text.

186. Upon news of a dividend reduction, which the broker knew was not public, the Cady, Roberts & Co. partner sold all of the company’s shares remaining in his discretionary accounts. 40 S.E.C. at 909. To avoid Rule 10b-5 liability, the Commission commented that the broker should have abstained from trading until procedures for public release of the information had been carried out. Id. at 915.
situations. Dirks had possession of information of a criminal nature that became more harmful the longer it remained secret. Repeated efforts had been made to bring the fraud to the attention of the authorities, with no result. Whether conscientious or not, Dirks determined that it was best to disclose his information immediately rather than to abstain and allow the fraud to go on unexposed.

The second policy statement of Dirks reaffirms the belief that brokers serve an important function in collecting, evaluating, and disseminating corporate information for public use and can be useful as criminal investigative tools. In fact, the Justice Department's Solicitor General noted after the court of appeals' opinion in Dirks that the decision might have an adverse effect on criminal law enforcement. The Supreme Court’s holding, on the other hand, may result in more exposure of corporate fraud by insiders. For example, an employee who has knowledge of his corporate employer's fraudulent conduct may fear retribution for disclosure of the information. An anonymous tip from the employee to a broker may result in a quicker assessment of and crackdown on the criminal activity, while maintaining the anonymity and security of the informant.

Brokers can be used as viable and legitimate criminal enforcement tools. The SEC has limited resources. The Commission has neither the finances nor the manpower to investigate every alleged wrongdoing in the exchange markets. The SEC acting alone is incapable of adequately regulating the markets. Nor can

187. See supra note 160 and accompanying text.
188. See supra note 88.
189. S.E.C. Dispute on Dirks Case, N.Y. Times, Nov. 2, 1982, at D2, col. 1. It may have been the Justice Department's opinion that the court of appeals was distorting Rule 10b-5 beyond its intent. In a footnote to the SEC's brief to the Supreme Court, the Solicitor General noted that Dirks was not subject to a fiduciary relationship with other traders and there was no element of misappropriation or other misconduct in obtaining or transferring the information. Id.; see also Note, Securities—Insider Trading: The Extension of the Duty to Disclose Material Inside Information, 58 NOTRE DAME L. REV. 132, 151 n.136 (1982).
190. Secrist claimed that Equity Funding "officers had Mafia connections which they used to threaten the lives of employees who objected to the . . . [insurance policy] fabrications." 681 F.2d at 829.
191. It was reported in the Wall Street Journal, regarding an SEC filing rule on insider stock trades, that SEC officials feel they "haven't enough money or workers to examine the filings closely for signs of illegal trading or improper reporting." Hudson, supra note 14.
192. See id. It is interesting to note that in 1971, the SEC performed only cursory investigations after receiving reports of questionable accounting practices at Equity Funding. Dirks, 681 F.2d at 832 n.6. The Commission took no further action. In 1973, after Secrist brought the matter to the attention of the insurance authorities, an SEC staff attor-
the press, which has had an historic role in discovering and exposing wrongdoing, bring criminal activity to light as swiftly in some instances as brokers can. Newspapers and journalists must work within the confines of reporting facts. A libel suit can be disastrous. This was precisely the conflict in Dirks. Dirks persistently urged a reporter for the Wall Street Journal to expose the alleged fraud that Secrist had disclosed to him. The reporter was afraid that publishing damaging "rumors," supported only by hearsay from former employees, might be libelous, so he declined to write a story.193

For these policy reasons, courts should construe the personal benefit requirement in favor of analysts and brokers who uncover fraudulent corporate activity. The efforts expended by brokers to expose fraud should not be chilled by fears of SEC retaliation. A broad interpretation of the personal benefit requirement should not be applied to brokers who disclose material nonpublic information about illegal corporate conduct.

C. Proposed Alternatives

Since the liberal personal benefit requirement does not lend itself to application in situations like the one encountered in Dirks,194 and the narrow interpretation arguably provides insufficient restraint,195 less obtrusive means of policing broker activity could be implemented. If the facts in Dirks arise again, the primary objective should be to expose the fraudulent corporate activity as quickly as possible. Neither the SEC nor the press can be effective in every instance. Brokers would be more effective if they were allowed to investigate alleged fraud and dishonesty reported to them and then to disclose this information to their clients without the fear of 10b-5 liability. The broker could make a conscious choice whether to expend his own resources in conducting a search such as that executed by Dirks. If there is no merit to the charges, then only the broker has "lost."196 Indeed, if the clients whom the broker ill-advised did sell, they may terminate their business rela-

193. See supra notes 78-79 and accompanying text.
194. See supra notes 182-93 and accompanying text.
195. See supra notes 175-80 and accompanying text.
196. One might actually consider the broker-advisor to have gained even if his search for wrongdoing proves fruitless, if it initiates or reaffirms a belief that the investigated company has commendable practices and honest management.
tionship with him. The broker may also be liable for defamation of the corporation which he has falsely accused of criminal behavior.\textsuperscript{197} If fraud is discovered, however, and a broker is permitted to disclose to his clients and prosper as a result of sell orders, then an adequate incentive is created to encourage brokers to accept the inherent risks in bringing corporate fraud to the public’s attention. Therefore, one alternative to the personal benefit requirement test is to prohibit criminal charges being filed against a broker who unveils a fraudulent corporate scheme and does not trade in the securities himself.

It must be emphasized that brokers should only be permitted to disclose and trade without becoming subject to Rule 10b-5 when the evidence reported to them is of corporate criminal activity. Only when the broker discloses nonpublic, material information about illegal corporate conduct is the injury to a minimum number of investors justified by the greater public good which accrues as the crime is quickly discovered and exposed. This rule would not alter the application or the effectiveness of Rule 10b-5 in any other way.

Another alternative is for the SEC to promulgate regulations specifically detailing disclosure procedures when a broker receives material nonpublic information concerning illegal corporate conduct.\textsuperscript{198} Nevertheless, if brokers are required to immediately report corporate fraud to the SEC and to refrain from disclosing such information to their clients, the harm and illegalities could continue indefinitely due to the insufficient resources of the SEC. A more realistic rule would require a broker to disclose corporate

\textsuperscript{197} A corporation can be defamed based on its honesty, credit, efficiency, and other business characteristics. \textit{See, e.g.}, \textit{Pullman Standard Car Mfg. Co. v. Local Union 2928}, 152 F.2d 493, 496 (7th Cir. 1945) (a corporation has a business reputation which is protected by law); \textit{Aetna Life Ins. Co. v. Mutual Benefit Health & Accident Ass’n}, 82 F.2d 115, 118 (8th Cir. 1936) (corporation has the right to bring a libel action for publication that attacks its credit or management and inflicts injury on its business or property); \textit{Maytag Co. v. Meadow Mfg. Co.}, 45 F.2d 299, 302 (7th Cir.), \textit{cert. denied}, 283 U.S. 843 (1930) ("the legal principles constituting the law of libel and slander are the same whether corporations or individuals are involved"). \textit{See generally W. PROSSER & W.P. KEETON, THE LAW OF TORTS 779 (5th ed. 1984) (defamation of corporations).}

\textsuperscript{198} The SEC took such an approach after \textit{Chiarella}. The Commission did not acquiesce in that decision and subsequently promulgated Rule 14e-3, 17 C.F.R. \S 240.14e-3 (1983), which makes unlawful the use of manipulative, deceptive, or fraudulent practices in connection with tender offers. \textit{Id; see also Heller, supra note 3, at 541 n.58.} In the same way that Rule 14e-3 more specifically details lawful tender offer practices, Rule 10b-5’s objectives and requirements could be redefined in order to enlighten investors, insiders, the SEC, and the courts as to its practical effects.
criminal behavior to the SEC. A ten-day period would then begin in which the broker could not disclose the information. The Commission would have ten days to determine the truth of the accusations against the corporation and to take any affirmative action. The expiration of the ten-day “grace” period would entitle the broker to disclose the information and permit tippees to trade on it even if the information was still nonpublic. Additionally, a rule could require that a complaint filed by a broker become a matter of public record when the grace period ends. In that way, unknowing purchasers would be afforded notice and an opportunity to further investigate a prospective securities investment.

The advantage of the above plan is that if the SEC believed it could be effective, it would have a specified number of days to prove it. If Dirks-type communication and trading occurred within that period allotted exclusively to the SEC, that activity would be a clear violation of the law. Hence, predictability would exist. Where the Commission did not take the initiative to investigate charges of fraud or dishonesty within ten days of the initial report, the cost would be that the alleged crime would be given extended life. In that instance, however, the possible harm to the public from a few additional days of nondisclosure would be much less than the injury to unwary purchasers if brokers and their clients were allowed to conduct business on nonpublic information during the same period. After the ten days, if the SEC had not confirmed the allegations, brokers would have the same incentives to investigate and disclose information in an attempt to unmask corporate fraud. Once it was recognized that the SEC would not conduct its own search, and that a crime may continue indefinitely, the balance would be struck in favor of permitting Dirks-type activity in the exchange markets.

If the purpose of the insider trading regulations is to protect investors, then another solution might be to impose only civil sanctions, but with treble damages, for all trading violations. By this alternative, unwary purchasers could be restored to their original status by reimbursement from the knowing seller. The treble damages would be a powerful deterrent against traders’ temptations to benefit illegally from their inside information.

If a balancing of interests approach is not applied, then the type of information that is conveyed to a broker and subsequently disclosed to clients without first being made public should be irrelevant in a Rule 10b-5 analysis, regardless of whether it concerns fraud, dividend increases, or deductions. Similarly, the important
role that a broker plays in unmasking a crime should be ignored if a balancing test is disregarded. If the interests of the public as a whole are to be overlooked, the courts must resolve 10b-5 cases strictly on the issues of duty and personal benefit or motive.

If the public wishes to have corporate fraud exposed and stopped as swiftly as possible, however, this latter option is to be strongly discouraged. The courts and the SEC have had obvious difficulty discerning predictable standards by which actions alleged to violate Rule 10b-5 can be measured. Both have been inconsistent in their interpretations of the elements of a 10b-5 violation. Brokers are unable to safely predict whether their disclosures will result in criminal or civil charges being brought against them.

VII. CONCLUSION

No clear impact on the behavior of brokers and investors is evident in the wake of the Supreme Court’s new personal benefit requirement. If courts use the new standard as a means of balancing brokers’ and traders’ justifications for insider trading against losses sustained by unknowing investors, then the personal benefit rule will be a hindrance to SEC prosecution of Rule 10b-5 cases against brokers who disclose material nonpublic information but do not trade personally. If the personal benefit test was contrived, on the other hand, as an exception in order to absolve only Dirks, then perhaps the new rule will be flexibly construed and easily satisfied in most insider trading cases. In that case, the personal benefit requirement will add nothing new to securities law.

Since an implicit goal of the securities laws is to minimize victimization of unwary investors,199 a narrow application of the personal benefit requirement should be administered to encourage disclosure of corporate fraud by brokers who might otherwise fear prosecution under Rule 10b-5. This assumes that brokers are permitted to reveal nonpublic information to clients concerning illegal behavior within a corporation without subjecting themselves to criminal or civil liability. If courts broadly rule that insiders personally benefit in some respect whenever they distribute information to brokers, the new rule will frustrate the efforts of brokers to research and disclose instances of corporate criminal activity that

199. See supra notes 22-29 and accompanying text.
might otherwise go undetected by the SEC or other enforcement agencies.

Ambiguity surrounds not only what is required to satisfy the component terms of Rule 10b-5, but also what are Rule 10b-5's specific requirements. Presently, there appears to be little, if any, predictability in the law with respect to Rule 10b-5. This is cause enough for defendants to raise serious arguments against most SEC allegations of insider trading. The need for clarification of the securities laws is most evident in the Dirks-type situation where a securities advisor, or any other individual, engaged in a good faith effort to uncover corporate criminal activity, must risk violating Rule 10b-5. Our society encourages the public to expose fraud and deceit, and it should not permit the threat of insider trading sanctions to have an adverse effect on criminal law enforcement. Furthermore, as long as commentators urge that there are significant economic reasons for engaging in insider trading, attempts to refine the respective securities laws to allow limited insider trading will appear.

Notwithstanding the attitudes one holds with respect to the purpose and effectiveness of the federal securities laws on insider trading, some changes are in order. Too many issues persistently remain unanswered. Without future legislative or agency action, Dirks will not be the Supreme Court's last word on Rule 10b-5.

---

200. For example, terms such as "insider," "material information," and "disclosure," are not delineated in the Rule.

201. See supra note 31.