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Dirks v. SEC - A Study in Cause and Effect

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DIRKS v. SEC—A STUDY IN CAUSE AND EFFECT

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I. INTRODUCTION

In *Dirks v. Securities and Exchange Commission*[1] the Supreme Court undertook, for the first time, to establish a standard for determining when persons who are not corporate insiders but who receive material, nonpublic information from an insider ("tippees") incur liability under section 10(b) of the Securities Exchange Act of 1934[2] and rule 10b-5[3] thereunder, for trading in the securities of the affected issuer or for revealing the information they receive to others who can reasonably be expected to trade. Dirks, a securities trader and analyst, was formally censured by the SEC for passing material, nonpublic information concerning fraudulent activities at Equity Funding Corporation of America (Equity Funding) to certain of his clients and investor colleagues.[4] Dirks had received nonpublic information that Equity Funding's assets were

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1. 103 S. Ct. 3255 (1983).

2. Section 10(b), 15 U.S.C. § 78j (1983), reads:

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.

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

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

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

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

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

4. *In re* Raymond L. Dirks, 21 S.E.C. Docket No. 17, at 1401, 1412 (Feb. 3, 1981).

"vastly overstated"[5] from, among others, a former insider of the company. Some of those to whom Dirks revealed this information quickly sold their holdings of Equity Funding stock and thereby avoided substantial losses when the massive fraud being conducted at the company was eventually made public.[6] Although he selectively revealed the information, Dirks also made certain efforts to convince others to publicize what he had learned and has been generally recognized as having played an important role in surfacing the Equity Funding scandal.[7]

Nevertheless, after an administrative proceeding, the SEC ruled that Dirk's conduct aided and abetted violations of, among others, section 10(b) of the Exchange Act and rule 10b-5 thereunder. The Commission's decision was based on its view that one who knows or should know that he has received material, nonpublic information from an insider assumes the insider's duty either to disclose that information to those with whom he trades or to refrain from trading.[8] The SEC ruled that a tippee breaches his assumed duty when he trades or tips others who reasonably can be expected to trade on the information.[9] The

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5. 103 S. Ct. at 3258.

6. *Id.*

7. *Id.* at 3259.

8. 21 S.E.C. Docket No. 17, at 1407, 1410 n.42. Brief for Respondent at 21-25, 30-31, Dirks v. SEC, 103 S. Ct. 3255 (1983) (arguing that Dirks acquired a duty to disclose by participating in the insider's breach).

Although rule 10b-5 contains no express prohibition against trading on material, nonpublic information, *see supra* note 3, the SEC and the courts have consistently interpreted the rule to so provide. *See generally* 1 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD § 4.2 (1979); *see also* cases collected at *id.* § 2.2, at 462, 463 (1980) (trading on material, nonpublic information treated as a violation of 10b-5). The basic premise of such liability has been that certain persons, such as corporate insiders, have a duty either to disclose or to refrain from trading while in possession of material non-public information to which they have access. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961); *In re* Ward La France Truck Corp., 34 S.E.C. 373 (1943). The courts generally recognize that an insider owes a duty to disclose not only to existing shareholders but also to anyone with whom he trades, for it would be "a sorry distinction to allow him to use the advantage of his position to induce the buyer into the position of a beneficiary [i.e., a shareholder], although he was forbidden to do so, once the buyer had become one." Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951), *quoted in Cady, Roberts*, 40 S.E.C. at 914 n.23 and Chiarella v. United States, 445 U.S. 222, 227 n.8 (1979). This formulation raises a prevailing issue concerning the true basis of an insider's duty to disclose to those with whom he trades. Should it be seen as arising from a fiduciary relationship with the other party to the transaction, or should it result from concepts such as the trader's "access" to confidential information, the need for market integrity and the market's expectation of fairness? This issue was central to *Chiarella* and *Dirks* and is the implicit focal point of much of this article.

9. 21 S.E.C. Docket No. 17, at 1407, 1410 n.42, *noted in* Dirks v. SEC, 103 S. Ct. at 3259, 3262. An issue raised by the SEC's standard is whether the tip must be accompanied by tippee trading in order to violate rule 10b-5. One commentator has suggested that tippee

lower courts had generally endorsed these principles since the Second Circuit's precedential *Texas Gulf Sulphur* decision.[10] The United States Court of Appeals for the District of Columbia Circuit agreed.[11]

But the Supreme Court refused to accept the notion that a tippee "assumes" an insider's duty to disclose by merely receiving what he knows or should know is material, nonpublic *inside* information.[12] Rea-

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trading is required since the mere tip does not itself constitute "deception," as required for liability under the rule. *See* Langevoort, *Insider Trading and the Fiduciary Principle: A Post* "Chiarella" *Restatement*, 70 CALIF. L. REV. 1, 25-26 (1982). *See also* Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1976) (absent deception or manipulation there is no 10b-5 violation). But he notes several decisions suggesting to the contrary. *E.g.*, SEC v. Lum's, Inc., 365 F. Supp. 1046, 1058 (S.D.N.Y. 1973). Since rule 10b-5(c) proscribes conduct that operates or "would operate" as a fraud or deceit upon any person, *see supra* note 3, it could be argued that the act of tipping itself could violate the rules. *See also* section 17(a) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. 77q(a) (1976) (proscribing conduct "which operates or would operate as a fraud or deceit upon the purchaser"); 15 U.S.C. 77q(a)(3) (1976). *But cf.* Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 165 (2d Cir. 1980) (stating that "if there is no trading by tippees (or those to whom the tippees convey their information), there can be no damages for tipping under § 10(b)"). The Second Circuit's reasoning in *Elkind*, however, does not preclude an injunctive action since it recognizes that a duty to the corporation may be breached despite the absence of tippee trading. *See id.* at 165 nn.14-15; U.S. v. Newman, 664 F.2d 12, 17 (2d Cir. 1981), *cert. denied*, 104 S. Ct. 193 (1983)(citing cases for the proposition that an injunctive action may be available to an issuer to stop tipping or trading on nonpublic corporate information).

10. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969) (enunciating general rule that "anyone in possession of material inside information must either disclose it to the investing public or . . . abstain from trading in or recommending the securities concerned . . . ."). *See* SEC v. Lund, [1981-82 TRANSFER BINDER] Fed. Sec. L. Rep. (CCH) ¶ 98,428 (C.D. Cal. Jan. 22, 1982) (summary judgment denied); SEC v. Geon Indus., Inc., 531 F.2d 39, 49 (2d Cir. 1976) (insider tipping merger information to broker); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236-38 (2d Cir. 1974) (tippees liable because they knew or had reason to know of confidential corporate source of negative earnings information; duty to disclose runs to entire marketplace); Kuehnert v. Texstar Corp., 412 F.2d 700, 702 (5th Cir. 1969) (plaintiff-tippee's purchases on what he thought was an accurate tip subject to defense of *in pari delicto*); Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967) ("If [defendants] were not insiders they would seem to have been 'tippees' . . . and are subject to the same duty as insiders.").

11. Dirks v. SEC, 681 F.2d 824, 839 & n.16 (D.C. Cir. 1982).

12. 103 S. Ct. at 3261-62. A distinction generally may be made between "market" or "outside" information and "corporate" or "inside" information, the former referring to information which affects the market for an issuer's securities but which generally does not affect its assets or earning power and comes from sources outside of the issuer, *see, e.g.*, Oppenheimer & Co., 46 S.E.C. 323, 323 n.2 (1976), and the latter referring to information which generally comes from within the issuer and affects its assets or earnings. *See, e.g.*, Fleischer, Mundehim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 798-99 (1973), *cited in Chiarella*, 445 U.S. at 240-41 n.1 (Burger, C.J., dissenting). Chief Justice Burger, in his dissent in *Chiarella*, rejected this distinction for purposes of rule 10b-5 liability, 445 U.S. at 240-41 n.1, while the majority specifically referred to "market" information at several points in its opinion. *Id.* at 229, 231, 233-35. The Court stated its holding in *Chiarella* in terms of "market" information: "We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic *market* information." *Id.* at 235 (emphasis supplied). The *Dirks* Court rejects any legal distinction between "market" and

soning from its holding in *Chiarella v. United States*,[13] that "mere possession of nonpublic market information" does not alone create a duty to disclose,[14] the Court held that a tippee acquires an insider's duty to disclose or refrain from trading only if the tipping insider has breached a fiduciary duty to shareholders in disclosing the information and the tippee knows or should know that there has been such a breach.[15] Moreover, the Court stated that an insider breaches his duty only when he "personally will benefit, directly or indirectly, from his disclosure."[16] Because Dirks was not himself an insider[17] and because, according to the majority, the insiders who "tipped" him had not violated any duty to Equity Funding's shareholders by telling Dirks of the company's illegal conduct,[18] the Court reversed the circuit court's affirmance of the SEC censure.[19]

The *Dirks* decision quickly was recognized as imposing new restrictions on the prohibition against trading on non-public information that has developed under rule 10b-5,[20] and as raising new questions about the scope and object of the rule.[21] These questions arise from the

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"inside" information under rule 10b-5. 103 S. Ct. at 3262 n.15. The terms, however, retain their pratical use in defining the various fact patterns into which trading cases typically fall. The terms will be used for that purpose in this article.

13. 445 U.S. 222 (1979).

14. *Id.* at 235.

15. 103 S. Ct. at 3258.

16. *Id.* at 3265.

17. *Id.* at 3266-67. The Court also noted that Dirks did not "induce the shareholders or officers of Equity Funding to repose trust or confidence in him," or "misappropriate or illegally obtain the information." *Id.* at 3267. The first observation may be meant to deal with the continuing viability of the Supreme Court's decision in Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (where a duty to disclose was imposed on outsiders of an issuer by virtue of their undertaking to act on behalf of certain shareholders in the sale of their stock). *See, e.g.*, *Chiarella*, 445 U.S. at 229-30. The latter statement may be of significance to alternate theories of liability under rule 10b-5 based on misappropriation of information as suggested in *id.* at 238-239 (Stevens, J., concurring) and 239-45 (Burger, C.J., dissenting). These theories will be discussed later. *See supra* text accompanying notes 128-39 & 155-56.

18. 103 S. Ct. at 3267 & n.27. Justice Blackmun, joined by Justices Brennan and Marshall in a dissenting opinion, specifically disagreed with this conclusion. *Id.* at 3270, 3272 n.13 (Blackmun, J., dissenting). He reasoned that the primary tipper, one Secrist, breached his duty to shareholders in disclosing the information to Dirks under the theory that an insider breaches his duty merely by virtue of making disclosures harmful to shareholders' interests. *Id.* at 3270-71. Moreover, although he disagreed with the majority's notion that some benefit to the insider is necessary to establish a breach of duty, Blackmun would have found a benefit to Secrist simply in "the good feeling of exposing a fraud and his enhanced reputation." *Id.* at 3272 n.13. The majority did not discuss those possibilities. *See supra* text accompanying notes 12-16.

19. 103 S. Ct. at 3628.

20. *See supra* note 8.

21. *See* Wermiel, *High Court's Decision on* Dirks *May Make SEC's Pursuit of Insider Trading Harder*, Wall St. J., July 5, 1983, at 5, col. 1; Pitt & Ain, "Dirks" *Deals Blow to SEC Insider*

Court's application of the common-law principles upon which it relies to define its tippee liability standard and from the policy shift which underlies the Court's articulation of those principles. The Court re-emphasizes the common-law principles that were relied upon in *Chiarella* to determine when a duty to disclose or refrain from trading may be imposed, and makes it clear that, as at common law, the duty must arise from a relationship of trust and confidence *between the parties to the transaction*. Moreover, the *Dirks* Court apparently standardizes this common-law duty approach of *Chiarella*—a case involving market information—as applicable to all cases of "silence" or nondisclosure of material facts under rule 10b-5,[22] whether the facts are considered to be market or corporate information about the securities in which the violater trades.[23] The Court's re-emphasis and uniform application of the principles of *Chiarella*, despite the arguably limiting approach applied to that decision by the lower courts and the SEC,[24] brings interpretation of rule

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Trading Progam, Legal Times, July 11, 1983, at 10, col. 1; Noble, *The* Dirks *Ruling: Insiders' License?*, N.Y. Times, July 16, 1983, at 29, col. 4; Sporkin, *Set Back to SEC's Enforcement Drive*, N.Y. Times, July 17, 1983, at F2, col. 2.

22. 103 S. Ct. at 3262 n.15. It is important to note that *Dirks*, as well as the other cases discussed in this article, involve, as far as rule 10b-5 is concerned, only violation of rule 10b-5(a) and (c). Subparagraph (b) of rule 10b-5 prohibits *statements* containing misrepresentations or *statements* which are misleading because the speaker omits to state necessary material facts. See *supra* note 3 for text of rule. The trading which Dirks was charged as aiding and abetting by his tipping presents a case of total silence, or failure to disclose information affecting the value of securities, and thus would be properly cognizable only under rule 10b-5(a) and (c). This, of course, will normally be the case when transactions are effected in the open market without face-to-face contact. *See, e.g.*, *Chiarella*, 445 U.S. at 225-26 & n.5. *But cf. Cady, Roberts*, 40 S.E.C. at 913 (suggesting that clause (b) is violated in such cases based on "an implied misrepresentation").

23. See *supra* note 12 for a discussion of the nature of market and inside information.

24. *See* United States v. Newman, 664 F.2d 12, 19 (2d Cir. 1981), *cert. denied*, 104 S. Ct. 193 (1983) (allowing a criminal action for violation of rule 10b-5 on facts similar to *Chiarella* on theory of misappropriation); O'Conner & Assocs. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179 (S.D.N.Y. 1981) (allowing action by option trader against two merging corporations, insiders of the corporations, and tippees on theory that breach of duty to corporation supports option trader's action for damages under 10b-5); SEC v. Lund, [1981-82 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,428 (E.D. Cal. Jan. 22, 1982) (defendant's summary judgment motion denied in light of three viable theories: that the defendant outsider was a tippee; that the outsider owed duty to issuer by virtue of relationship with tipping insider; and that the outsider misappropriated the information); SEC v. Lund, 570 F. Supp. 1397 (1983) (judgment entered for SEC, after *Dirks*, on ground that tippee's business relationship to tipper made him a temporary insider). *But cf.* Laventhall v. General Dynamics Corp., 704 F.2d 407, 412 (8th Cir. 1983) (denying private rule 10b-5 action and emphasizing need for relationship of trust and confidence between the parties); Moss v. Morgan Stanley, Inc., 553 F. Supp. 1347, 1352-56 (S.D.N.Y), *aff'd*, 719 F.2d 5 (2d Cir. 1983) (dismissal of private damage action because no relationship between plaintiff and defendants), *cert. denied sub nom.* Moss v. Newman, 104 S. Ct. 1280 (1984). *See generally* Chazen, "Dirks" *Presents Unique Corporate, Social Issues*, Legal Times, March 14, 1983, at 14, col. 1 (discussing limiting interpretations of *Chiarella*, adopting theory of tippee liability accepted in *Dirks*).

10b-5 closer to the common-law concepts which it was developed to replace.[25]

By referring to these restrictive principles, the Court announces its new rules for the liability of tippees and tipping insiders. In doing so, the Court clearly enunciates, as a primary policy in the area of trading on nonpublic information, its concern for promotion of market efficiency through the work of analysts and other market professionals and for predictability of liability under rule 10b-5 by these persons and by insiders who may pass confidential corporate information.[26] Although these goals are relevant to interpretation of the antifraud provisions of the federal securities laws, the Court's logic and ruling significantly tip the previous balance of the policies underlying those provisions: The balance is swung from one favoring assurance of market integrity and investor protection through close circumscription of the selective use of confidential corporate information by insiders and *all* of their tippees to one allowing selective and systematic dissemination of such information to market professionals in the name of efficiency in pricing. *Dirks* stands as a victory for the proponents of market efficiency as a justification for insider trading. Any remnant of the "equal information" or "parity of information" theory is gone.[27] But more importantly, *Dirks* sounds the

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25. *See* Herman & MacLean v. Huddleston, 103 S. Ct. 683, 690 (1983) ("[W]e have repeatedly recognized that securities laws combating fraud should be construed 'not technically and restrictively, but flexibly to effectuate [their] remedial purposes.' ") (brackets in original) (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 195 (1963), citing in accord, Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971); Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972)); 103 S. Ct. at 691 ("[T]he antifraud provision of the federal securities laws are not co-extensive with common-law doctrines of fraud. . . . [A]n important purpose of the federal securities statutes was to rectify perceived deficiences in the available common law protection."); White v. Abrams, 495 F.2d 724, 734 (9th Cir. 1974) (recognizing "the necessity of departing from the rigid standards of the common law if the goals of the securities laws are to be accomplished"). *See also* Justice Blackmun's dissent in *Chiarella*, 445 U.S. at 248 ("[The purpose of the securities laws] is to ensure the fair and honest functioning of impersonal national securities markets where common-law protections have proved inadequate.") (citation omitted); Langevoort, *Fraud and Deception by Securities Professionals*, 61 TEX. L. REV. 1247, 1261-62 (1983) ("Although the legislative intent behind [the antifraud provisions of the federal securities laws] suggests that common-law fraud principles are a starting point for analysis, it also suggests a mode of interpretation responsive principally to the particular types of abuse to which the laws are addressed rather than to history."). *See generally* Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U.L. REV. 627, 651 (1963) ("It is clear that Congress was conscious of the fact that it was changing the law of fraud.").

26. 103 S. Ct. at 3263-66 nn.17-18 & 24; *see infra* text accompanying notes 68-69.

27. The equal information or parity of information theory rests on the premise that the best way to achieve the goals of fairness and market efficiency under the securities laws is to allow all investors relatively equal access to material information. Thus, it is reasoned, all trading on material information which is not generally available is fraudulent. *See generally Dirks v. SEC*, 681 F.2d at 835 & n.14 (discussing the information theory and alternatives);

death knell for a middle-ground approach to outlawing insider trading based on the justifiable expectations of the marketplace as defined by notions of fairness and market integrity.

After briefly sketching the *Chiarella* decision, this article will discuss the reasoning of the *Dirks* decision, will evaluate the effectiveness and the ramifications of the legal principles and the policy shift which the Court endorses, and will discuss the uncertainties which the decision fosters. In response to the Court's permissive rules of tippee liability, the article will suggest a possible judicial broadening of those rules. Finally, this article will explore the effects of the Court's duty analysis in *Chiarella* and *Dirks* on the development of legal theories in cases involving trading on nonpublic information—specifically, theories of liability for both outsiders and insiders trading on market information and for outsiders trading on inside information.

II. *CHIARELLA*—UNANSWERED QUESTIONS

At the outset, the Court in *Dirks* refines and re-emphasizes the duty concepts it endorsed in *Chiarella*. Chiarella, while employed by a financial printer, was able to discern the confidential identity of takeover targets of certain of his employer's clients from tender offer materials that he was preparing. He then purchased securities of the targets, reaping profits when the price of the securities rose after the tender offer announcements.[28] Chiarella was indicted and convicted of criminal violations of section 10(b) and rule 10b-5. The Court of Appeals for the Second Circuit affirmed his conviction, reasoning that "anyone . . . *who regularly receives* material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose."[29] The circuit court thus adopted a modified version of the so-called parity of information theory.[30]

The Supreme Court reversed Chiarella's conviction, holding that "mere possession of market information" does not create a "duty to disclose" on which can be based a violation of rule 10b-5 for trading on nonpublic information.[31] The Court embraced the common-law fraud

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Brudny, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 *passim* (1979) (supporting a modified parity of information theory).

28. 445 U.S. at 224.

29. United States v. Chiarella, 588 F.2d 1358, 1365 (2d Cir. 1978) (emphasis added).

30. The Second Circuit's position in *Chiarella* is not a strict adoption of the parity theory. Rather the court based its rule on the notion that it is unfair to allow those who occupy "strategic places in the market mechanism" to trade on non-public information which they "regularly" receive merely by virtue of those "strategic" positions. *Chiarella*, 588 F.2d at 1365.

31. 445 U.S. at 235. This holding is not directly responsive to the Second Circuit's standard because that standard rested on more than mere possession of market information.

precept that such a duty arises from "a relationship of trust and confidence."[32]

Chiarella, thus, largely resolved the argument between those who would create a general obligation to refrain from trading on nonpublic information based solely on the notions of fairness and market integrity, which underlie the parity of information theory, and those who would limit the obligation to disclose by some reference to common-law concepts of fiduciary relationships. But the Court left unanswered important issues concerning the nature and origin of possible duties which may form the basis for liability under rule 10b-5. The language of the opinion suggests that a duty to disclose to the other party to the transaction may be the exclusive duty a breach of which is sufficient to support a rule 10b-5 violation.[33] The opinion also suggests that such a duty must arise from a relationship between the transacting parties.[34] If both of these premises are endorsed, liability under rule 10b-5 may be limited to those who have an existing fiduciary relationship with the party with whom they happen to trade—an extremely restrictive result.

Apparently recognizing this, several concurring or dissenting justices attempted to narrow the majority opinion to mean only that a person trading on *market* information must breach "some duty."[35] Limiting the Court's holding in this way leaves open the possibility of distinguish-

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32. 445 U.S. at 228 ("[T]he duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.' ") (brackets in original) (citing RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)) (additional citations omitted); *id.* at 230 ("Silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b) . . . . But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction."); *id.* at 231-32 ("The Court of Appeals like the trial Court, failed to identify a relationship between petitioner and the sellers that could give rise to a duty."); *id.* at 233 ("Formulation of . . . a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties, . . . should not be undertaken absent some explicit evidence of congressional intent.").

33. *Id.* at 228 ("[O]ne who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so."); *id.* at 229 ("The cases have also emphasized, in accordance with the common-law rule, that '[t]he party charged with failing to disclose market information must be under a duty to disclose it.' ") (brackets in original) (citation omitted); *id.* at 232 ("[T]he element required to make silence fraudulent—a duty to disclose—is absent in this case."). *See* Langevoort, *supra* note 9, at 50 n.201; Pitt & Ain, *supra* note 21, at 15, col. 1 (suggesting that absent an affirmative misstatement, the trader must be under a duty to disclose to incur rule 10b-5 liability).

34. *See supra* note 32.

35. Justice Brennan, concurring in the judgment in *Chiarella*, took issue with the suggestion in the majority opinion that "no violation of § 10(b) could be made out absent a breach of some duty arising out of a *fiduciary relationship between buyer and seller*." *Id.* at 239 (emphasis added). He agreed with the Chief Justice's dissenting view that an absolute duty to disclose may arise from misappropriation of non-public information. *Id.*; *see also id.* at 237-38 (Stevens, J., concurring) (defendant owed duty of silence to employer's customers); *id.* at 251

ing cases of trading on *inside* information or of basing liability, and even a duty to disclose, on the defendant's breach of some duty which he may owe to a third party.[36] After *Chiarella*, the lower courts and private litigants advanced several alternate theories of liability for trading on market information in cases in which there was no preexisting relationship between transacting parties upon which to base a duty to disclose. One such theory, the so-called "misappropriation theory," as developed in *United States v. Newman*,[37] rests not on a duty to disclose to those with whom one deals in the marketplace but rather on a breach of the duties of "honesty, loyalty and silence"[38] owed to the source of confidential information or to agents to whom the source has entrusted the information.[39] A second misappropriation theory, advanced by Chief Justice Burger in his dissent in *Chiarella*, does rest on a duty to disclose. The Chief Justice posited that anyone who misappropriates confidential information automatically incurs a duty to disclose to those with whom he trades, regardless of the lack of any pre-existing relationship between the transacting parties.[40] These theories appeared as viable alternatives under the *Chiarella* Court's duty analysis because of the questions which the opinion left open.

The *Dirks* opinion, in its general discussion of the elements of a duty to disclose, sheds new light on the questions raised by *Chiarella*, and concomittantly affects post-*Chiarella* theories of liability for trading on nonpublic information. The next section of this article will analyze the reasoning and the policy shift which the *Dirks* Court endorses in setting down its new rules of tippee liability. After discussing the resulting uncertainties, it will suggest a judicial response to those uncertainties. A discussion of the effect of the Court's reasoning and rules on the duty issues raised in this section will be the subject of the last section of this article.

III. TIPPEE LIABILITY: THE NEW POLICY

A. Derivation of the Rules of Tippee Liability

The *Dirks* Court relies heavily on its holding in *Chiarella* that "mere possession" of nonpublic market information is insufficient to create a

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(Blackmun, J., dissenting) (defendant cannot trade on information resulting from a structural informational disparity).

36. *See* cases cited *supra* note 24.

37. 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 104 S. Ct. 193 (1983). *See infra* text accompanying notes 132-38 (discussion of facts in *Newman*).

38. 664 F.2d at 16.

39. *Id.* at 17-18.

40. 445 U.S. at 239-45.

duty to disclose. The SEC sought to limit the application of *Chiarella* to cases involving market information and to impose a duty to disclose on all who possess inside information by virtue of the confidential, corporate nature of the information.[41] But the Court, expanding on the concepts of *Chiarella*, specifically refused to treat mere possession of inside information any differently than the mere possession of market information:

> As we emphasized in *Chiarella*, mere possession of non-public information does not give rise to a duty to disclose or abstain; *only a specific relationship does that*. And we do not believe that the mere receipt of information from an insider creates such a special relationship between the tippee and the corporation's shareholders.[42]

Thus the Court viewed *Chiarella* as announcing the basis for liability in all cases of trading on undisclosed information: "*Chiarella* made it explicitly clear that there is no general duty to forego market transactions 'based on material nonpublic information.' "[43]

Relying on the common-law notion that only a "specific relationship" creates a duty to disclose, the *Dirks* Court held that an outsider-tippee, who has no special relationship to the corporation or its shareholders, must derive a duty to disclose from an insider's *breach* of his fiduciary duty to shareholders: "[A] tippee assumes a fiduciary duty to shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."[44] Noting that "a purpose of the securities laws was to eliminate 'use of inside information for personal advantage,' "[45] the Court stated that an insider breaches his fiduciary duty by tipping information only if he "personally will benefit, directly or indirectly, from his disclosure."[46] In the absence of a benefit to the insider, a tippee is apparently unrestricted in his trading on, or

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41. 103 S. Ct. at 3262 n.15.

42. *Id.* (emphasis added). The Court specifically noted the SEC's proffered distinction between "inside" and "market" information, but mistakenly reversed the definitions—referring to the latter as " 'information generated within the company relating to assets or earnings,' Brief for Respondent 23." The Court continued: "This Court drew no such distinction in *Chiarella*, and, as the CHIEF JUSTICE noted, '[i]t is clear that § 10(b) and Rule 10b-5 by their terms and by their history make no such distinction.' " *Id.*

43. *Id.* at 3267 n.27.

44. *Id.* at 3264.

45. *Id.* at 3265 (citing *Cady, Roberts*, 40 S.E.C. at 912 n.15).

46. *Id.*

tipping of others for the purpose of trading on, nonpublic inside information.

But the Court is not writing in a vacuum. It has just revised an entire body of law that defined liability for trading on nonpublic inside information by reference to the notion that concern for fairness and market integrity demands relatively equal access to information material to investment decisions. The parity of information theory had its roots in the SEC's seminal decision in *In re Cady, Roberts & Co.*[47] and was more expansively articulated in the Second Circuit's *Texas Gulf Sulphur* opinion and later SEC decisions.[48] In *Cady, Roberts* the SEC found that

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47. 40 S.E.C. 911 (1961).

48. A commentator who assisted in writing the *Cady, Roberts* opinion, *see* Symposium, *Insider Trading in Stocks*, 21 BUS. LAW. 1009, 1009 (1966) (discussion among William L. Cary, Arthur Fleischer, Jr., and Thomas A. Halleran), posited, just prior to the Second Circuit opinion in *Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968) that "the federal securities laws . . . may be interpreted to impose a duty of disclosure if the expectations of the market place necessarily contemplate such a requirement." Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the* Texas Gulf Sulphur *Proceeding*, 51 VA. L. REV. 1271, 1279 (1965) (footnote omitted). The Second Circuit adopted this approach, stating: "[T]he rule (10b-5) is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information . . . ." *Texas Gulf Sulphur*, 401 F.2d at 848 (citing Symposium, *supra*, at 1010; Fleischer, *supra*, at 1278-80). The court stated that the expectations of the marketplace require imposing a duty to disclose on anyone who possesses material nonpublic inside information. *Id.*

The SEC specifically adopted the Second Circuit's approach in *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933 (1968), in which it held an underwriter liable for selective disclosure of negative information which it had obtained as managing underwriter. Then, in *In re* Investors Management Co., 44 S.E.C. 633 (1971), the SEC held one of the tippees of the respondent in *Merrill Lynch* liable merely because it knew or had reason to know that the material information it received "was nonpublic and had been obtained improperly by selective revelation or otherwise . . . ." *Id.* at 641, 643. The SEC dramatically expressed its adoption of an approach based on the expectations of the market and fairness:

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

Id. at 639.

> We reject the contentions advanced by respondents that no violation can be found unless it is shown that the recipient himself occupied a special relationship with the issuer or insider corporate source giving him access to nonpublic information, or, in the absence of such relationship, that he had actual knowledge that the information was disclosed in a breach of fiduciary duty not to reveal it.

Id. at 643. *But cf. id.* at 648-51 (Comm'r Smith, concurring)(expressing concern for the role of analysts; interpreting *Cady, Roberts*, *Texas Gulf Sulphur*, and *Merrill Lynch* as having emphasized "the conduct of corporate insiders and their privies" and expressing preference for a rule, endorsed in *Dirks*, requiring a breach of duty by an insider to impose liability on an outsider).

The notion that the marketplace expects and is owed disclosure of nonpublic inside information was confirmed in a line of cases from the Second Circuit. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236 (2d Cir. 1974), *cited with approval in*

a broker-dealer firm and one of its partners violated rule 10b-5 when they traded for select customers in the securities of an issuer while in possession of material, nonpublic information concerning a dividend cut at the issuer. The information had been obtained from a partner in the firm who was also a director of the issuer. The *Dirks* Court summarizes the *Cady, Roberts* decision as one in which the SEC found that breach of the common-law "affirmative duty of disclosure"[49] satisfied the elements of a rule 10b-5 violation.[50] The Court thus apparently concludes that in *Cady, Roberts*, the SEC adopted common-law standards as the basis for rule 10b-5 liability.[51]

The SEC did look to the existing common-law duty of an insider to impose an additional obligation on an insider under rule 10b-5 not to trade on nonpublic, inside information.[52] But it emphasized that in establishing principles for liability under rule 10b-5, it would depart from the common law and seek to serve its mission to protect all investors.[53] In fact, the SEC adopted very broad elements in *Cady, Roberts* for determining when persons *other* than insiders would be liable for trading while in possession of confidential information. After noting that "the antifraud provisions are phrased in terms of 'any person' " and that of-

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Dirks, 103 S. Ct. at 3261, n.14; Elkind v. Liggett & Meyers, Inc., 472 F. Supp. 123, 128 (S.D.N.Y. 1978), *rev'd in part on other grounds and aff'd in part,* 635 F.2d 156 (2d Cir. 1980). In those two cases the courts allowed damage actions against persons trading on inside information by everyone who trades in the marketplace contemporaneously with the defendants. Thus, the courts imposed a duty to disclose running to the entire market and not just shareholders. Such a duty, it seems, must rest to some extent on the expectations of the market and not simply a relationship of trust between buyer and seller.

Finally, as pointed out *supra* text accompanying notes 28-36, the Second Circuit in its opinion in *Chiarella* opted for a test based on the concept of fairness and the expectations of the market, and the United States Court of Appeals for the District of Columbia in *Dirks* also cogently expressed its preference for such an approach. *See Chiarella*, 588 F.2d at 1365-68; *Dirks*, 681 F.2d at 835 & n.14.

49. 103 S. Ct. at 3260.

50. *Id.*

51. Pitt & Ain, *supra* note 21, at 13, col. 1 (interpreting *Cady, Roberts* as a case in which "the SEC predicated the duty of insiders under Rule 10b-5 . . . on [their] common law duty").

52. 40 S.E.C. at 911. ("An affirmative duty to disclose material information has been traditionally imposed on corporate 'insiders,' particularly officers, directors or controlling stockholders.") The quoted language suggests the SEC's belief that the three categories do not encompass all those who could be considered insiders. Also, the SEC noted that the majority state rule did *not* impose such an obligation, *id.* at 911 n.13, thus signalling its intention not to be bound by common law.

53. *See id.* at 910 ("So many times that citation is unnecessary, we have indicated that the purchase and sale of securities is a field in special need of regulation for the protection of investors."); *id.* at 911 ("These antifraud provisions . . . are designed to encompass the infinite variety of devices by which undue advantge may be taken of investors and others.").

ficers, directors and controlling shareholders traditionally have a duty not to trade on nonpublic information, the SEC stated:

> These three groups, however, do not exhaust the classes of persons upon whom there is such an obligation. Analytically, the obligation rests on two principal elements; first, the existence of *a relationship giving access*, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of *anyone*, and second, the *inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing*.[54]

These elements, apparently applicable to any party, are indeed expansive.[55] The "relationship" requirement is stated in broad terms of "access" to information intended for a corporate purpose—not in terms of fiduciary responsibilities. The generally stated concern for fairness, although apparently limited by the first element of access, brings the standard for imposing liability close to a standard premised on the parity theory—relatively equal access by investors to material information.

Undaunted by this broad language and policy concern, the *Dirks* Court, ostensibly relying on *Cady, Roberts*, ties the imposition of an obligation to disclose nonpublic information before trading to common-law concepts of fiduciary relationships. The Court first recognizes that in *Cady, Roberts*, "[t]he SEC found that not only did breach of [an insider's] common-law duty . . . establish the elements of a Rule 10b-5 violation, but that individuals other than corporate insiders could be obligated either to disclose . . . or to abstain from trading altogether."[56] But, ap-

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54. *Id.* at 912 (footnote omitted) (emphasis added).

Although the SEC went on to state: "Thus our task here is to identify those persons who are in a special relationships with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in securities," *id.*, the overwhelming thrust of the opinion demonstrates a willingness to depart from common-law standards for determining such duties, if necessary to protect investors and advance the policies of the securities laws. Indeed, *Cady, Roberts* held that a tippee who personally had no relationship with the issuer was liable under rule 10b-5 although the SEC specifically noted facts demonstrating an absence of any breach of duty by the tipper. *Id.* at 917. *See also In re* Investors Management Co., 44 S.E.C. 633 (1971), discussed *supra* note 48, in which the SEC rejected the argument that there is no violation absent a relationship affording access. Note also the divergence from strict common-law duty analysis in Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951) which the *Chiarella* Court cited approvingly to justify holding insiders liable for impersonal, open market sales of securities to nonshareholders based on nonpublic inside information. *Chiarella*, 445 U.S. at 227 n.8.

55. Under a broad reading, the *Cady, Roberts* standard would prohibit the conduct of Messrs. Chiarella and Dirks regardless of their lack of any fiduciary or trust relationship to trading shareholders. *See* Fleischer, *supra* note 48, at 1282; Ruder, *supra* note 25, at 667-70; Comment, *The Prospects For Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L. REV. 1120, 1142-44 (1950).

56. 103 S. Ct. at 3260 (footnotes omitted) (emphasis added).

parently creating a general standard for liability under rule 10b-5 for trading on nonpublic information, the Court states:

> In *Chiarella*, we accepted the two elements set out in *Cady, Roberts* for establishing a Rule 10b-5 violation: "(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."[57]

The subtle changes in the *Cady, Roberts* standard and the blending of *Chiarella*—a case involving market information—with *Cady, Roberts* and *Dirks* is not incidental. Rather, it evinces the Court's view that under the federal securities laws, liability for trading on nonpublic information—whether market or inside information—is premised on the breach of the type of fiduciary duty imposed on an insider at common law. The majority in *Dirks* thus limits the class of relationships upon which a duty can be based to a narrower class than that contemplated by the notion of "a relationship affording access" advanced in *Cady, Roberts*.

The second element of the *Cady, Roberts* standard, unfairness, which describes "the harm that the duty protects against,"[58] is restrictively rephrased by the *Dirks* Court in terms of the unfairness of allowing a corporate *insider* to take advantage of confidential *inside* information. The Court thus views the unfairness in trading on nonpublic information as tied to an insider's misuse of that information. This limitation is also inconsistent with the principles enunciated in *Cady, Roberts*. It seems basic to any concept of fairness that shareholders and potential shareholders of a company who enter the securities markets should not have to compete with anyone who has the advantage of having received inside information to which those shareholders do not have access and which was to redound to the benefit of all shareholders. Because inside information, as the *Dirks* Court concedes, is "intended only for a corporate purpose and not for the personal benefit of anyone,"[59] liability should properly rest not on whether an insider has breached a duty in tipping the information, but rather on the unfairness of allowing any "party [to take] advantage of such information knowing it is unavailable to those with whom he is dealing."[60]

The Court's modification of the fairness concept of *Cady, Roberts*

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57. *Id.* (citing 445 U.S. at 227)(emphasis added).

58. *Id.* at 3271 n.8 (Blackmun, J., dissenting).

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

60. *Id.* Although this would seem to require adopting a strict parity rule, it may be modified according to how unavailability is defined. Professor Brundy, for example, would outlaw

goes a long way towards reversing the prior development of rule 10b-5. *Cady, Roberts* was only a starting point, and the SEC and the courts soon focused implicitly on the principle of "fairness" which seems to have been the real concern of *Cady, Roberts*.[61] This led to the development of rule 10b-5 based on the rationale that investor confidence was enhanced through application of the rule by reference to considerations of what constitutes the "justifiable expectations of the marketplace" in disclosure of nonpublic information prior to trading in securities.[62] In fact, the Second Circuit in *Chiarella* opted for a version of this approach, apparently based on the *Cady, Roberts* elements of "access" and "fairness."[63] And the United States Circuit Court of Appeals for the District of Columbia Circuit in *Dirks*, in a lengthy footnote, noted the long existing tension "between the 'information' theory and the 'fiduciary' theory" and expressed its preference for a middle-ground theory, based on "the two major ideals of the federal securities laws: fairness to investors and efficient markets for capital."[64]

The Supreme Court in *Chiarella* and *Dirks*, however, has chosen a restrictive common-law approach to rule 10b-5, disregarding the middle-ground approach advanced by the appellate courts in those cases. The Court's strict reference to the common law forecloses the development of the proper expectations regarding the use of nonpublic information in today's complex securities markets. Any surviving notion of liability based on the *Cady, Roberts* concepts of "access" and "unfairness" is to be viewed from the rigid classifications of an insider's duty at common law, not the remedial purposes of the federal securities laws.[65]

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trading if the trader has an "unerodeable informational advantage," i.e., access to information that may not be obtained lawfully by others. Brundy, *supra* note 27, at 353-68.

61. *See supra* note 48; *see also Chiarella*, 445 U.S. at 248-51 (Blackmun, J., dissenting)(discussing *Cady, Roberts* and evolution of rule 10b-5).

62. *See supra* note 48; *see also Chiarella*, 445 U.S. at 248-51 (Blackmun, J., dissenting).

63. The Second Circuit's rule would have outlawed trading on nonpublic market information by those with "regular" access to information that they did not create by their own skill or judgment. *See supra* notes 12, 27; *Chiarella*, 588 F.2d 1358, 1365-66 (2d Cir. 1978).

> For the securities markets to function properly, it is essential that those who occupy such strategic places in the market mechanism be forbidden to reap personal gains from information received by virtue of their position.
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> . . . A test of "regular access to market information" appears to us to provide a workable rule. There should be no greater difficulty in resolving close cases than is inherent in determining who is a "corporate insider" under *Texas Gulf Sulphur*.

Id. (citation omitted).

64. *Dirks*, 681 F.2d at 835 n.14. (Judge Wright believed that the two goals were served by limiting *Chiarella* to cases involving market information and adopting the SEC's approach to liability for tippees of inside information.)

65. The rigid standards of the common law seem singularly ill suited for application to the complexities and expectations of modern securities transactions. As the Senate Commit-

The Court articulates a reason for its restriction of the *Cady, Roberts* "access" and "fairness" standard: "Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market."[66] The remainder of the opinion is dominated by justification of the Court's new rules of tippee-liability through general reference to the benefits that market analysts confer on the securities markets by contributing to "efficiency in pricing."[67]

The importance of the Court's preference for the role of analysts and market professionals cannot be understated. The Court, reluctant to support a rule that might ensnare all recipients of *market* information in *Chiarella*,[68] now extends that reluctance to cases involving inside information. Any question of whether market professionals can utilize either market or inside information seems largely resolved in favor of allowing trading.

B. Policy Basis for the Rules

Supporting its holding, which allows analysts to trade on nonpublic information absent any benefit to an insider, the Court notes that "the

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tee reporting out the Exchange Act stated, "so delicate a mechanism as the modern [securities markets] cannot be regulated efficiently under a rigid statutory program." S. REP. NO. 792, 73rd Cong., 2nd Sess. 5 (1934).

66. 103 S. Ct. at 3263 (footnote omitted).

67. *Id.* at 3263 n.17. *See* Pitt & Ain, *supra* note 21, at 13, col. 2 ("This preoccupation with the effect of the SEC's theories on market professionals permeates the Court's *Dirks* decision . . . .").

68. *See* 445 U.S. at 232-35.

In *Chiarella*, the Court justified its concern over a general prohibition of trading on material, nonpublic market information by reference to the "detailed and sophisticated regulation" of the uses of market information which have evolved even to allow, in some instances, selective use of such information. *Id.* at 233. One provision commonly cited as an example of how Congress has specifically legislated an allowable informational advantage involving market information is section 11(a) of the Exchange Act, 15 U.S.C. § 78k(a) (1983). That section prohibits market professionals from trading for their own accounts while in possession of nonpublic market information received by virtue of their position, but specifically exempts exchange specialists, i.e., firms that make a market in specific securities traded on a national exchange. This proves little. The history of the SEC's opposition to such trading, as well as its consideration of total segregation of broker and dealer functions even as to specialists on the exchanges, is well chronicled. *See* J. SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SEC AND MODERN CORPORATE FINANCE 75, 100, 121, 145-49, 177-78, 236 (1982). That Congress and the SEC have dealt with specific allowable informational advantages by statute and rulemaking, it could be argued, indicate the intention otherwise to disallow such advantages. The specific provisions of the federal securities laws that allow utilization of these advantages need not be usurped by application of rule 10b-5.

information analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analyst's judgment in this respect is made available in market letters *or otherwise to clients* of the firm."[69] The Court concludes that "[i]t is the nature of this type of information . . . that [it] cannot be made simultaneously available to all of the corporation's stockholders or the public generally."[70] Accepting this suspect conclusion as true, it begs the real question: Why *should* analysts and their selected clients be entitled to trade on material, nonpublic inside information before shareholders or the general public receives that information? The Court's main task is to explain how a rule allowing such inequity benefits the market, the corporation's shareholders, or anyone other than those fortunate enough to have access to an analyst who has access to a corporate insider.

The Court relies on the efficiency arguments often advanced by those who would remove any prohibition on insider trading. Those arguments generally are premised on two basic assumptions: that trading on inside information is an economical means of compensating corporate executives and that market efficiency in pricing securities is advanced by allowing even indirect injection of significant information into the market.[71] The Supreme Court rejects the notion that insider trading is a permissible form of compensation.[72] Rather, its new rules are based on the market efficiency rational for insider trading. This leads back to the initial question in more specific terms: Do the specific benefits to be obtained by allowing a stock price to rise to its "efficient" level through trading on inside information outweigh the damage that may be done to market integrity? Indeed, is there any guarantee, or even a reasonable certainty, that the price will rise "efficiently" through trading on nonpublic inside information? More importantly, one must ask whether there is any alternative method of allowing dissemination of inside information without the harm to shareholders and to market integrity attendant to the Court's rules. This article will not analyze in depth the arguments against the market efficiency justification for inside trading. But to understand the implications of the *Dirks* decision, it is important to note what the Court does and does not consider important

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69. 103 S. Ct. at 3263 (emphasis added).

70. Id.

71. *See generally* H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966) (analyzing and defending insider trading); Seligman, *An Economic Defense of Insider Trading*; FORTUNE, Sept. 5, 1983, at 847 (overview of Manne's argument). *See also* Heller, Chiarella, *SEC Rule 14e-3 and* Dirks: *"Fairness" versus Economic Theory*, 37 BUS. LAW. 517, at 525-26 (1982) (analysts' use of nonpublic information increases market efficiency).

72. This is obvious from the personal benefit test. If an insider benefits from a tip, he may incur liability under the *Dirks* rule. *See supra* text accompanying notes 44-48.

to justify its new rules. This section first will compare the benefits to market efficiency to be derived from the *Dirks* standards and those to be derived from the SEC's position. It will then focus on the shifting of the risks involved in market transactions which the Court's market efficiency policy entails and on the resulting uncertainties in determining liability under rule 10b-5.

1. Is There a Need for a New Rule?—The *Dirks* majority accepted that but for Dirks' facilitation of selected persons' sales of Equity Funding stock and the resulting fall in the stock's price, the Equity Funding scandal would not have surfaced—at least when it did.[73] But allowing trading on nonpublic information by a select few to guard against recurrence of the "extraordinary facts"[74] in *Dirks*, would be a case of making the cure worse than the illness. The Court is more generally concerned with efficient securities markets and the "serious ramificaitons on reporting of investment views,"[75] which the Court believes that the SEC's rule could entail. But allowing insider trading, or *any* tippees to trade on nonpublic information, will not necessarily ensure that all information relevant to the valuation of securities is reflected immediately in the marketplace. Even in instances of a major event in the life of a corporation, such as a merger, an acquisition, or a major fraud as in *Dirks*, most persons with access to inside information will try to minimize the market effect of their trades. Any market reaction to their buying or selling may decrease their profits when favorable information becomes public or may hamper their efforts to avoid losses before the announcement of negative news. The Court's rules also increase the instances in which the select few with access to nonpublic information may misjudge its ultimate effect on the market or in which persons may gain access to premature or inconsistent information and buy or sell affected securities in volumes or at prices which will create inefficiencies. Moreover, the market reaction to trading activity that is premised on nonpublic information may adversely affect confidential corporate negotiations or proposed transactions.

The SEC's pre-*Dirks* rule arguably preserved the efficiency of the securities markets as well as do the Court's rules. Prior to *Dirks*, it was generally accepted that analysts should be allowed only "to obtain from management corporate information for purposes of 'filling in the "inter-

73. 103 S. Ct. at 3258-59, 3259 n.8, 3263 n.18.

74. *Id.* at 3265.

75. *Id.* at 3263 n.18.

stices in analysis". . . .' "[76] The *Dirks* Court rejects this as insufficient to allow analysts to form investment "judgments."[77] The Court's rules clearly allow analysts to trade legally on *material* nonpublic information. The Court may be concerned that without a rule permitting the use of material information, analysts will be missing little bits and pieces of important information that are helpful to all market participants. But, true analysis has a large base of public information already available on which to proceed, and, indeed, presumes an absence of additional information.[78] And the SEC's rule does not restrict an analyst from trading on nonpublic information that results from an analysis of various nonmaterial, nonpublic facts. The prohibition rather comes into play only when one finds a true corporate asset—information material in itself or in light of additional salient facts.[79]

The weakness of the Court's market efficiency justification is evident even in the *Dirks* opinion. While seeking to justify its new tippee-liability rules by relying on the importance of the work of analysts "to ferret out and analyze information . . . ,"[80] the Court admits that Dirks' conduct did not fall within these parameters: "[Dirks] uncovered . . . startling information that required *no analysis or exercise of judgment* as to its market relevance."[81] The Court thus legally approves of Dirks' conduct, while distinguishing it from the conduct which the Court's new rule is designed to promote. Moreover, the Court recognizes that inside

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76. *Id.* at 3263 n.17 (quoting SEC's brief, Brief for Respondent at 42, which quoted *Investors Management Co.*, 44 S.E.C. at 646.

77. *Id.* ("This rule is inherently imprecise, and imprecision prevents parties from ordering their actions in accord with legal requirements.").

78. *The SEC and Corporate Disclosure "A Program by Committee on Federal Regulation of Securities,"* 36 BUS. LAW. 119, 138 (1980) (comments by C. Reed Parker) (discussing effect of increased information on the role of market analysts); *see also* West, *Timely Disclosure — The View From 11 Wall Street*, 11 SW. L.J. 241, 244 (1970) ("[T]he competent security analyst depends on his professional skills and his broad industry knowledge in making evaluations and does not need to depend on inside information which would provide him with an unfair advantage.").

79. *See* SEC v. Monarch Fund, 608 F.2d 938, 942 (2d Cir. 1979) (nonpublic corporate information concerning proposed financing lacked sufficient specificity to bring any duty to disclose or abstain into operation); SEC v. Bausch & Lomb, Inc., 565 F.2d 8, 14-15 (2d Cir. 1977)(duty to disclose arises when information would have considerable effect on the market price of the security); *see also* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (For a fact omitted from a proxy solicitation to be material "there must be substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."). The lower courts have generally applied this standard in rule 10b-5 cases. *See* Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 166 (2d Cir. 1980); Zweig v. Hearst Corp., 594 F.2d 1261, 1266 & n.8 (9th Cir. 1979).

80. 103 S. Ct. at 3263 n.17 (citation omitted).

81. *Id.* at 3263 n.18.

information is a "corporate asset" which insiders must not mismanage but which, under the Court's policy, can be made available to select outsiders before being directly disclosed to the owners of the corporation (its shareholders). The owners must rely on receiving an uncertain and, at best, indirect notice of the information by interpretation of market movements to be spurred by the outsiders' riskless use of the information.

The most significant omission in the *Dirks* opinion is the failure to discuss whether its overriding concern for market analysis, or "efficiency in pricing," is paramount, as the Court has made it, under the antifraud provisions of the securities laws. As the SEC repeatedly emphasized in *Cady, Roberts*, "investor protection" from all types of frauds and inequities in the market was in fact the paramount concern of the securities laws.[82] It is difficult to reconcile the Court's presumption of a general interest in efficiency in pricing with the long established and Congressionally mandated concern for market integrity and fairness. This is especially so in view of the increasing of risks to investors which results from the Court's application of that policy.

2. Unexplained Shifting of Risks to Investors.—The Court addresses the obvious objection that under its rule unsuspecting shareholders will be trading with better informed outsiders, by noting: "as market values fluctuate and investors act on inevitably incomplete or incorrect information, there are always winners and losers; but those who have 'lost' have not necessarily been defrauded."[83] They have entered the market, so the argument goes, voluntarily, the market price having been right for them. This, of course, is obviously true, but it neither addresses the inherent unfairness of the situation or the potential harm to market integrity, nor justifies increasing the number of winners and losers—the inevitable result of the Court's rule. An analyst may be undecided as to an investment decision, but as he receives material nonpublic information, barring illegality, he certainly will enter the market, along with many of his clients. If the market price is affected by this added volume, more "losers" may enter the market. Thus, the Court has shifted the

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82. *See supra* note 53 and accompanying text; *see also* cases cited *supra* note 25; Baird v. Franklin, 141 F.2d 238, 244 (2d Cir. 1944) (Clark, J., dissenting in part) ("One of the primary purposes of Congress in enacting the Securities Exchange Act of 1934 was to protect the general investing public."); Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943), *cert. denied*, 321 U.S. 786 (1944) ("[T]he essential objective of securities legislation is to protect those who do not know market conditions from the over-reaching of those who do."); U.S. v. Naftalin, 441 U.S. 768, 774 (1979) ("[B]oth this Court and Congress have emphasized the importance of the [Securities Act] in protecting investors . . . .").

83. 103 S. Ct. at 3267 n.27.

risks that the inevitable "winners and losers" undertake as they enter the market in response to price movements.

Market traders inevitably have "incomplete or inaccurate" information to the extent that the law recognizes that a corporation has a legitimate interest in conducting certain of its business in private.[84] Congress, and the SEC, through the disclosure provisions of the federal securities laws[85] and the courts in case law[86] have sought to adjust corporations' need for confidentiality against shareholders' need for adequate, accurate, and timely corporate information. The *Dirks* Court has readjusted the existing balance between the competing interests without reference to this body of law. If more timely market disclosure is necessary, the Court should consider whether some adjustment of corporations' obligation to disseminate inside information may be a more appropriate means.

Obviously, difficult issues involving the timing and the manner of

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84. *See, e.g.*, SEC v. Texas Gulf Sulphur & Co., 401 F.2d 833, 850 n.12 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969) ("We do not suggest that material facts must be disclosed immediately; the timing of disclosure is a matter for the business judgment of the corporate officers . . . within the affirmative disclosure requirements promulgated by the exchanges and by the SEC."); *Insider Trading in Stocks*, 21 BUS. LAW. 1009, 1023-26 (1966) (comments of Thomas A. Halleran, member of New York Bar); Fleischer, *supra* note 48, at 1295, 1299-1300.

85. *See e.g.*, 15 U.S.C. § 78 (1983); *id.* § 78m(a) (periodic reports as the SEC prescribes by rule); *id.* § 78m(d) (information required in event of five percent beneficial ownership of equity securities); *id.* § 78m(e) (information as required by rules in event of issuer repurchase); *id.* § 78n (information required in event of proxy solicitation or tender offer); *id.* § 78o(d) (periodic reports of certain issuers); *id.* § 78p(a) (information required of officers, directors, or ten percent beneficial owners); *see also* Securities Act Release No. 5092, [1970] FED. SEC. L. REP. (CCH) ¶ 77,915 (Oct. 15, 1970) (discussing duty of prompt disclosure); Securities Act Release No. 5699, [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,461, at 86,202-03 (reminding issuers of duty of prompt disclosure of material facts); NYSE COMPANY GUIDE SECTION A-Z, PART II (obligation of listed companies to make prompt disclosure); AMEX COMPANY GUIDE PART 4, § 402(1) (same).

86. Ross v. A.H. Robins Co., 465 F. Supp. 904 (1979) (duty to correct prior statements that become materially incorrect; action dismissed on grounds that section 18 of Exchange Act provided exclusive remedy and failure to plead with particularity), *rev'd*, 607 F.2d 545 (2d Cir. 1979); *cf.* Goldberg v. Meridor, 567 F.2d 209, 221 n.10 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978) (noting that commentators suggest that rule 10b-5 is adequate basis for affirmative duty to disclose). *But see* State Teachers Retirement Bd. v. Fluor Corp., 654 F.2d 843, 850-51 (2d Cir. 1981) (company has no duty to correct rumors not attributable to company); Staffin v. Greenberg, 672 F.2d 1197 (3d Cir. 1982) (no duty to disclose preliminary merger discussions if not trading); Schlanger v. Four-Phase Systems, Inc., [Current Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,724, at 97,947 (S.D.N.Y. 1984) (motion for summary judgment denied; no duty to announce inchoate merger discussions). *See generally* Bauman, *Rule 10b-5 and the Corporation's Affirmative Duty to Disclose*, 67 GEO. L.J. 935 (1979) (suggesting that rule 10b-5 imposes duty of prompt disclosure of material events); Talesnick, *Corporate Silence and Rule 10b-5: Does a Publicly Held Corporation Have an Affirmative Obligation to Disclose?*, 49 DEN. L.J. 369 (1973) (same).

disclosure, as well as the nature of legitimate business justifications for failure to disclose material information promptly, are presented by such an approach.[87] The Court's assumption that analysts need and have a right to material, nonpublic information prior to the rest of the public may stem in part from a desire to avoid burdening the corporation with a disclosure requirement. But, it is arguable that the burden in this area should fall largely on the corporation and not on its shareholders. At least, these considerations should be analyzed before preference is given to one of the competing interests.

The *Dirks* Court, however, finds it sufficient to refer to "the central role . . . that analysts . . . play in revealing information that corporations may have reason to withhold from the public. . . ."[88] It never asks the questions: If a corporation has a legitimate reason to withhold information, why should an analyst be allowed to reveal or use it, or if it has no legitimate interest in confidentiality of certain information, then why should the information not be disclosed equally to all shareholders, if to any? Without addressing whether, in the proper case, some expansion of the obligation of affirmative corporate disclosure would be a more appropriate means of ensuring pricing efficiency, the Court creates the possibility that an uninformed shareholder will be trading with an analyst or its client who has received material information directly from the shareholder's company.

Perhaps more significant than freeing analysts from liability for the use of nonpublic information, is what the Court's rules do to clarify the liability of insiders and to adjust the risks attendant to discussing nonpublic information with outsiders. Prior to *Dirks*, even if an insider received no conceivable benefit from disclosure of information to an analyst—or, indeed, even if he disclosed information pursuant to company policy or direction—he (and the corporation) could be liable under rule 10b-5.[89] It is at this level that *Dirks* creates the greater potential for freeing confidential corporate information. While *Dirks* allows analysts to pursue corporate information more aggressively, without fear of liability if they are successful in dislodging something material, insid-

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87. *See* Bauman, *supra* note 86, at 948-62; Talesnick, *supra* note 86, at 407-11. Of course, these issues were not raised in *Dirks*. But if the perceived need for prompt reflection of nonpublic corporate information is the Court's main concern, it should have considered other possible ways of meeting that concern before resolving the issue at the expense of corporate shareholders.

88. 103 S. Ct. at 3263 n.18.

89. *See* Elkind v. Liggett & Meyers, Inc., 635 F.2d 156, 165-68 (2d Cir. 1980) (corporation liable for tippee trading resulting from authorized discussion with analyst); SEC v. Geon Indus., Inc., 531 F.2d 39, 49 (2d Cir. 1976) (insider and company liable because disclosure within scope of duties).

ers may be more amenable to analysts' overtures, since they too escape liability, absent personal benefit. Thus, the Court has shifted the risks associated with the market's quest for nonpublic information away from the corporate insiders and analysts (who would be liable for passing the information or would be unable to trade on it under the SEC's view) to the shareholders—who, after *Dirks*, are fair game for an informationally loaded analyst.[90]

D. Uncertainty Resulting from the Quest for Certainty

The Court's "personal benefit" test for determining when an insider has breached his duty in tipping information, seems largely an attempt to avoid what the Court views as the "inherently imprecise" nature of the SEC's rule[91] and to establish some certainty for liability under rule 10b-5. Yet, the Court finds itself admitting that the new rule will in fact cause uncertainty, and will "not always be easy," for courts to apply.[92] Indeed, the Court immediately creates a per se rule:

> The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.[93]

Even this attempt at specificity immediately raises a question: When does an analyst become a "friend" for purposes of the Court's per se rule? The question aptly illustrates the uncertainty injected into the law of trading on inside information which will result from a search for a definition of the Court's personal benefit test.

Uncertainty stemming from the anomolous and undefined nature of a "personal benefit" is further demonstrated by reference to fact situations such as in *Elkind v. Liggett & Myers, Inc.*.[94] In that case, insiders who were meeting with analysts disclosed nonpublic inside information concerning, among other things, corporate earnings. There is no indication in the opinion that the insiders benefited from their disclosure. The district court had found that the corporation routinely "gave inside tips to analysts in order 'to cultivate good relationships with selected finan-

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90. This is not to suggest that some self-policing will not occur. Indeed, if an analyst with inside information has direct contact with a buyer or seller, he may incur a duty to disclose based on rule 10b-5(b), which prohibits misleading statements.

91. 103 S. Ct. at 3263.

92. *Id.* at 3266.

93. *Id.*

94. 635 F.2d 156 (2d Cir. 1980).

cial analysts who followed Liggett.' "[95] Even if the insiders had invested in the corporation's stock and thus could be presumed to be attempting to induce a market movement favorable to their position, they could simply await the corporation's normal earnings announcement—which in the *Elkind* case followed the violative tippee trading by only one day. Under such circumstances, the mere holding of a position in the corporation's securities could not easily be linked to an improper attempt to benefit through "tipping."[96] Nevertheless, *Elkind* considered the selective disclosure of earnings a violation of rule 10b-5, prior to *Dirks*.[97] Under the "benefit" test, it is likely that no liability would attach.[98]

Until the courts have more clearly defined the type of personal benefit which will establish liability, even cases such as *Elkind*, which otherwise seem clearly to fall within the protection intended to be afforded insiders by *Dirks*, are subject to uncertainty. For example, it is conceivable that an insider would be deemed to have gained a personal benefit from tipping if the recipient is an analyst at a brokerage firm which has given the insider a favorable commission rate or an opportunity to participate in a desirable initial public offering in the past or which may do so in the future. If an analyst is employed by a financial publication, the insider must also consider whether a personal benefit could be al-

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95. *Id.* at 167.

96. *See, e.g.*, State Teacher's Retirement Bd. v. Fluor Corp., [Current Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,601 (S.D.N.Y. motion for summary judgment denied Dec. 12, 1983). In denying defendants' motions for summary judgment, after *Dirks*, as to a claim for improper tipping, the court noted, but did not hold, that various factors in the case, including the technicality of the issues involved, "provide strong temptation, if not compulsion, to reach the legal conclusion that proof of stock ownership alone and performance of an assigned duty cannot suffice to constitute the personal or reputational benefit described in *Dirks*." *Id.* at ¶ 97,361.

97. 635 F.2d at 168.

98. Absent an imminent corporate announcement of the information tipped, the insider could be seen as having personally benefited from the perceived benefit to the corporation in cultivating good relationships with the analyst, especially if the insider is also a stockholder and will benefit from increased trading in the company's stock. Such a view is difficult to reconcile with the policy of *Dirks* because it would seem to fulfill the benefit test in almost every case—insiders are also usually stockholders. Any other view raises the problem of potentially attributing personal motivation to insiders who tip analysts, which will be difficult to uncover. The Court views its test as an objective one that involves reference to "objective criteria" such as "pecuniary gain or reputational benefit that will translate into future earnings." 103 S. Ct. at 3266. The above analysis, however, points to the danger of using a vague "personal benefit" test to judge the conduct of fiduciaries who have potentially conflicting motivations and the means and discretion available to disguise those motivations. *See infra* note 109. For these very reasons, absolute liability for "short-swing" trading profits by "insiders" was imposed under section 16(b) of the Exchange Act, 15 U.S.C. § 78p(b) (1982). *See* STOCK EXCHANGE PRACTICES, REPORT OF THE COMMITTEE ON BANKING AND CURRENCY, S. REP. NO. 1455, 73rd Cong., 2d Sess., 55 (1934).

leged based on a past article favorable to the insider's reputation or the potential for such an article in the future.

Further uncertainty stems from the practical considerations attendant to directing corporate actions under the rule. It is yet to be seen how insiders will fair under the possible increased pressure on them to disclose nonpublic information. This pressure may result from competition to maintain a following of analysts, which can be important to retaining strength in demand for the corporation's stock and the market confidence which truly objective analysis by such professionals brings to bear. Should insiders easily succumb, the danger that premature, inconsistent, or incomplete information will be disclosed increases. Liability can result for both the corporation and for insiders who trade while such information is uncorrected.[99] On the other hand, there will be pressure to maintain confidentiality, not only due to normal business needs, but from the interplay of possible state law liabilities,[100] stock exchange contractual obligations,[101] and considerations of corporate integrity in the eyes of the public. These uncertainties will remain until the *Dirks* personal benefit test is more clearly defined.

The Court's response to the dissent's and SEC's concern that the benefit test permits an insider to fabricate easily "some ostensibly legitimate business justification for transmitting the information" suggests another uncertainty in rule 10b-5 liability.[102] Although the Court states

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99. *See, e.g.*, Heit v. Weitzen, 402 F.2d 909, 913 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969) (liability even absent trading); SEC v. Texas Gulf Sulphur, 401 F.2d 833, 858-62, 864 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969) (liability for ambiguous general statement); HSC, Inc. v. Daniels, [Current Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,557 (N.D. Ill. 1983) (corporation liable under "fraud on market" theory even in absence of direct reliance on the inaccurate statements by those trading); *see also* Securities Exchange Act Release No. 20,560 (Jan. 13, 1984) (reminding registrants that the antifraud provisions apply to all statements by company spokespersons, even if made in private, that can reasonably be expected to reach investors).

100. *Cf.* Broply v. Cities Serv. Co., 31 Del. Ch. 241-243, 70 A.2d 5, 7, 8 (1949) (fiduciary may not trade on own account when possessing knowledge from beneficiary); Diamond v. Oreamuno, 24 N.Y.2d 494, 497-98, 248 N.E.2d 910, 912-13, 301 N.Y.S.2d 78, 80-81 (N.Y. 1969) (allowing action by issuer to recover profits from trading insiders because corporation has interest in reputation to ensure market-ability of securities). Although *Diamond* and *Broply* both reasoned that one in a relationship of trust and confidence should not be allowed to benefit personally from access to inside information, the rational of those cases easily extends to an insider trading on unauthorized tips from which, under *Dirks*, he does not benefit. That is, an unauthorized tip may damage the company's reputation of integrity as quickly as an insider trading on, or personally benefiting from, inside information.

101. N.Y.S.E. COMPANY MANUAL, §§ A2, A-20 (corporate employees, directors, and officers must not disclose confidential information they may receive in the course of their duties); A.M.E.X. COMPANY GUIDE, Part 4, §§ 403, 403(6) (everyone who possesses material, nonpublic inside information is considered an insider under the A.M.E.X. policies).

102. 103 S. Ct. at 3265.

that in determining whether the insider's purpose in disclosing is fraudulent, "the SEC and the Courts are not required to read the parties' minds,"[103] it states in a footnote:

> Contrary to the dissent's suggestion, . . . *motivation is not irrelevant to the issue of scienter*. It is not enough that an insider's conduct results in harm to investors; rather, a violation may be found only where there is "*intentional or willful conduct* designed to deceive or defraud investors by controlling or artificially affecting the price of securities."[104]

To the extent that inquiry into motivation is inconsistent with a standard of recklessness or knowing misconduct, the Court's statement suggests that something less than specific intent will not satisfy the scienter requirement of rule 10b-5.[105]

E. Suggested Judicial Response

The Court justifies its new tippee-liability rules by reference to two goals: enhancement of certainty for insiders and analysts in dealing with disclosure of material information,[106] and assurance of prompt re-

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103. *Id.*

104. *Id.* at 3265 n.23 (emphasis added).

105. The SEC must prove scienter in injunction actions under section 10(b) and rule 10b-5 and under section 17(a)(1) of the Securities Act, but not under section 17(a)(2) & (3). Aaron v. SEC, 446 U.S. 680, 691, 697 (1980). In *Aaron*, the Court did not define what constitutes scienter, but stated that section 10(b) "quite clearly evinced a congressional intent to proscribe only 'knowing or intentional conduct.' " *Id.* at 690 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197-99 (1976)). Thereafter, various courts have interpreted the scienter requirement to require something less than a specific intent to defraud. *See* SEC v. Falstaff Brewing Corp., 629 F.2d 62, 77 (D.C. Cir.), *cert. denied*, 449 U.S. 1012 (1980) ("knowledge of what one is doing and the consequences of those actions suffices"); Edward I. Mawod & Co. v. SEC, 591 F.2d 588, 596 (10th Cir. 1979) (Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) "does not require that there be premeditated malice."); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 45 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978) (scienter has been defined as "knowing or intentional misconduct," but "knowing" implies conduct which is something less than intentional); SEC v. Blatt, 583 F.2d 1325, 1334 (5th Cir. 1978) (" 'knowing' conduct satisfies the scienter requirement"); Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 273 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979) ("[participation] in . . . a scheme with full knowledge of the consequences of [one's] act" satisfies the scienter requirement); Nelson v. Serwold, 576 F.2d 1332, 1337-38 (9th Cir.), *cert. denied*, 439 U.S. 970 (1978) (requires only that misstatements or omissions be made "with knowledge"); Berdahl v. SEC, 572 F.2d 643, 647 (8th Cir. 1978) (petitioner's knowledge sufficient to constitute scienter, no clarification of standard for knowledge); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1044 n.16 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977), ("*scienter* short of specific intent is sufficient").

106. 103 S. Ct. at 3263 nn.17-18, 3266 n.24. When the Court discusses the need for its personal benefit test, the only examples of permissable disclosure that it presents are those in which it is not "clear—either to the corporate insider or the recipient analyst—whether the information [is] material nonpublic information," and in which "[insiders] mistakenly think the information already [is] disclosed or . . . not material." *Id.* at 3265.

flection of important information in the securities markets.[107] But, as discussed above, the rules increase the potential for harm to corporate confidentiality, individual shareholders, and market integrity. Moreover, the rules cannot guarantee increased market efficiency and, by the Court's own admission, foster new uncertainty of liability through problems of interpretation and application. In light of these factors, the lower courts should attempt to minimize the potential harm from the rules and to inject an element of stability back into the once relatively settled law of trading on inside or corporate information. This can be done in several ways.

The most obvious approach to these problems is to attempt to define the Court's "personal benefit" test or to identify specific categories of conduct that the test reaches. The *Dirks* Court itself begins this process when it creates a per se rule or an irrebuttable presumption of personal benefit when "an insider makes a gift of confidential information to a trading relative *or friend*."[108] The potentially expansive net of liability envisioned in finding a personal benefit to an insider by virtue of his making a *gift* of a tip to a *friend* suggests that a very small and, more importantly, an intangible benefit will suffice.[109]

It would be consistent with this approach to bring potential reputational benefit within the ambit of "personal benefit." The Court seems to anticipate this when it states that "a pecuniary gain or a reputational benefit that will translate into future earnings" is sufficient to satisfy the test.[110] But the Court's language seems only to envision a reputational benefit which at least has the potential to become a tangible or pecuniary one. Nevertheless, almost any reputational benefit has that potential, and the Court's statement should not limit the notion that an intangible benefit is sufficient, because the Court does not purport to

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107. *Id.* at 3263, nn.17-18, 3266 n.24.

108. *Id.* at 3266 (emphasis added).

109. Justice Blackmun aptly described the difficulty of discerning the motivations of a tipping insider:

> The Court's approach is particularly difficult to administer when the insider is not directly enriched monetarily by the trading he induces. For example, the Court does not explain why the benefit [which the insider who tipped Dirks] obtained—the good feeling of exposing a fraud and his enhanced reputation—is any different from the benefit to an insider who gives the information as a gift to a friend or relative.
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> . . . The distinction between pure altrusion and self-interest has puzzled philosophers for centuries; there is no reason to believe the courts and administrative law judges will have an easier time with it.

103 S. Ct. at 3272 n.13. The issue may be more readily resolved by reference to objective criteria, requiring corporate authorization for tipping before a presumption of reputational or personal benefit is overcome.

110. *Id.* at 3266.

give an all-inclusive list of possible personal benefits that satisfy the test. Furthermore, bringing potential reputational benefit within the prohibition is necessary to provide for the situation of improper disclosure by an insider who merely wishes to "puff" or benefit his reputation as "in the know" or a "source." Although some pricing efficiency may be obtained by such tipping, it also may cause inefficiency because if the purpose of the tip is to puff one's reputation, the insider may be inclined to puff the substance of the information conveyed.

This discussion raises two larger problems to be resolved under the personal benefit test: Will the potential for any type of future benefit satisfy the test; and will the insider be liable if he benefits, but the corporation had authorized the tip? If the answer to the first question is yes, few may escape liability because it is as easy to conceive of potential future benefits as it is to fabricate ostensibly legitimate reasons for passing inside information. Yet, if the answer is no, then all tipping insiders escape liability except those who are so involved in the tipper's trade as to reap an immediate benefit. The better result is to find a breach if the insider seeks a future benefit. Indeed, when a future benefit is anticipated, the insider would seem to violate his fiduciary duty as clearly as if he received an immediate tangible reward. The answer to the second question is, under the literal language and the rationale of *Dirks*, yes. *Dirks* rests on the *Cady, Roberts* duty to disclose to shareholders, not on a duty owed to the corporation.[111] Thus, acting consistently with the wishes of the corporation should not be a defense to liability if the insider has personally benefited. Furthermore, if corporate consent to or benefit from the disclosure could cancel the liability of an insider who personally benefits from his selective disclosure, then the Court's rule is transformed into one which allows insiders to trade on nonpublic information as long as the corporation approves—a notion the Court clearly rejects.[112]

Prohibiting tipping where the potential for reputational or future benefit is involved may create difficulty in application of the Court's rules to situations which involve direct, authorized discussions between corporate officials and analysts—discussions which the Court's rules were seemingly designed to foster. But such cases can be resolved by looking to the particular circumstances of each case to determine

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111. *See supra* text accompanying notes 55-57. The Court distinguished between "[t]he duty that insiders owe to the corporation's shareholders not to trade on inside information . . . [and] the common-law duty . . . to the corporation not to mismanage corporate assets . . . ." 103 S. Ct. at 3260 n.10.

112. 103 S. Ct. at 3263 ("[I]nsiders [are] forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage . . . .").

whether the tip was designed to benefit the insider. Corporate authorization to disclose, although not automatically suspending liability, could be a relevant factor for determining whether an insider derived a personal benefit from the disclosure.

This discussion demonstrates the inherent tension between the concepts of market efficiency and market integrity, which the Court's personal benefit test exacerbates. Although "personal benefit" must be defined loosely to avoid the problems that the permissive use of inside information presents to corporate confidentiality and market integrity, defining it too loosely threatens to chill the communication between corporate officials and market analysts that the Court's rules are designed to encourage. Because it is difficult to achieve definitional specificity in the "personal benefit" test, these problems will emerge in almost every case.

One possible solution, which does not directly involve defining "personal benefit," is to create a presumption of personal benefit. Presumptions are often raised for valid policy purposes or to avoid problems of proof, especially when the facts needed to prove a particular matter are within the possession of or are more easily accessible to one party.[113] Indeed, a presumption of undue influence is raised in transactions between a fiduciary and the fiduciary's beneficiary specifically to protect relationships of trust *viz*. those who are in relationships of trust should be especially accountable for their conduct because the beneficiary may not have access to the information necessary to attack the fiduciary's conduct.[114]

A presumption of personal benefit in the context of securities transactions between a tippee of an insider and the insider's beneficiaries is similarly justified. Shareholders will find it difficult to discover their fiduciaries' true motivations and expectations in tipping the outsiders who thereafter trade with the shareholders. Raising a presumption of a personal benefit would temper the problems created by the ease with which an insider can fabricate an ostensibly legitimate business purpose for disclosing nonpublic information. A general presumption of personal benefit to a tipping insider also helps to preserve the corporation's legitimate interest in its confidential information and allows it to retain

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113. *See* Morgan, *Presumptions*, 12 WASH. L. REV. 255, 257-59 (1937); *see also* Don D. Anderson & Co. v. SEC., 423 F.2d 813, 817 (10th Cir. 1970) ("presumption" that stock which was used in computing net capital requirements under SEC regulations was not readily convertible into cash because of absence of a professional market and petitioners were more likely to have knowledge of a ready market than SEC).

114. Comment, *Presumptions in Texas: A Study in Irrational Jury Control*, 52 TEX. L. REV. 1329, 1342-82 (1974) (discussing examples of presumption of undue influence in transactions between a fiduciary and beneficiary).

more control over disclosure of that information. If an insider shows either that the release of information was authorized or that it substantially benefited market efficiency—the *Dirks* Court's main goal—then the burden of proving actual benefit would shift back to the plaintiff.

A presumption of personal benefit is consistent with the *Dirks* Court's reasoning. The *Cady, Roberts* duty to shareholders, as viewed by the *Dirks* Court in forming its rules of tippee liability, is primarily based on the unfairness of allowing an insider to take advantage of corporate information.[115] Thus, the corporation and its shareholders, who may be damaged by unauthorized disclosure even if an insider does not improperly benefit, should be protected by a presumption that the insider benefited, i.e., that there is some unfairness in the insider's use of the information. This is especially so in light of the remedial purposes of the anti-fraud provisions of the federal securities laws and the clear policy of enhancing market integrity expressed in the Exchange Act.

The policy underlying the only explicit prohibition of trading on inside information by insiders under the Exchange Act—section 16(b)—also supports this approach. That section provides that, "For the purpose of preventing unfair use of information which may have been obtained" by officers, directors, or holders of ten percent of an issuers' registered equity securities, the corporation may recover all profits resulting from the purchase and sale by such persons within any six month period.[116] The section thus effectively creates an irrebuttable presumption that such trades were with the use of confidential inside information. Creating a rebuttable presumption of personal benefit to insiders would be consistent with the Congressional recognition of the dangers inherent in the availability and use of confidential inside information.[117]

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115. *See supra* text accompanying note 44; *see also* 103 S. Ct. at 3264.

116. Section 16(b) of Exchange Act, 15 U.S.C. § 78p(b) (1983), provides:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months.

117. Justice Blackmun noted that the SEC's suggested rule could be construed to include a presumption of insider benefit from tipping, but that the Court's rule requires a case-by-case approach. 103 S. Ct. at 3272 n.13 (Blackmun, J., dissenting). If the SEC's rule included a presumption, it was an irrebuttable one because no provision was made for a tippee escaping liability on a showing that an insider did not benefit from the tip. The raising of a rebuttable presumption of personal benefit, absent a showing of a lack of benefit to the corporation's

Another logical extension of the coverage of the *Dirks* rules is to prohibit spouses and perhaps close friends of insiders from trading on information obtained from the insider regardless of whether the insider breached a duty to shareholders.[118] This principle—the concept of identity of interest—avoids the recurring situation in which an insider's spouse or close associate inadvertently or innocently learns about a merger, acquisition, or other material event and uses the information to trade.[119] The insider may tell his or her spouse of an imminent, material event to explain lengthened working hours or trips, or the spouse may simply deduce the upcoming event from out-of-the-ordinary activities, a telephone call, or other conversations. Presuming this conduct to be a violation of rule 10b-5 seems contrary to the Court's notion of liability stemming from breach of a fiduciary relationship, but the presumption of an identity of interest avoids the serious problems of proof which these situations present and the potential for carte blanche use of nonpublic corporate information when an insider reveals information to a spouse or close friend for an ostensibly legitimate purpose. To allow such trading would be to subvert the corporation's interest in confidentiality.

Therefore, it appears appropriate and to be a logical extension of the Court's purposes and reasoning in *Dirks* for the courts: (1) to hold that both intangible benefits and potential reputational benefits to an insider satisfy the "benefit test" for imposing tippee-liability; (2) to raise a rebuttable presumption that a tipping insider has directly or indirectly benefited from the tip, which should be rebutted by a showing that the tip was authorized or has substantially enhanced market efficiency; (3) to impose liability for trading on material, inside information by spouses and certain close associates of insiders based upon a constructive breach of the insider's duty, which is imposed upon them by virtue of their "identity of interest" with the insider. In the absence of such rules, the SEC's fear, expressed in *Dirks*, that it will be "a rare situation when the

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shareholders, is not inconsistent with the Court's case-by-case approach. Allowing the presumption to be rebutted by a showing of authorization for a "tip" would protect the free discussion between analysts and insiders which the Court seeks to enhance. Although the *Dirks* Court did not discuss the need for a presumption of personal benefit, it is clear that it viewed the use of the tipped information by Dirks as dramatically enhancing market efficiency. *See supra* note 73.

118. Fleischer, *supra* note 48, at 1281; West *supra* note 78, at 245-46; Comment, *supra* note 55, at 1144.

119. *See, e.g.*, SEC v. Kapachunes, No. 83-5368 (S.D.N.Y. July 20, 1983), (consent decree) (action against tippees of chairman of board's wife, who allegedly gained information either directly from or by overhearing husband; neither chairman nor wife were sued); SEC v. National Kinney Corp., No. 80-3683 (S.D.N.Y. Jun. 30, 1980), (consent decree) (wife alleged to have tipped sister after learning of potential acquisition through husband's meeting at home).

parties could not fabricate some ostensibly legitimate business justification"[120] is indeed well taken.

IV. EFFECTS OF THE *CHIARELLA-DIRKS* APPLICATION OF COMMON-LAW PRINCIPLES TO ALL TRADING CASES

A. Effect on Cases Involving Outsiders Trading on Market Information

As discussed above, the *Chiarella* and *Dirks* common-law fiduciary duty approach to liability under section 10(b) and rule 10b-5 in cases involving trading on nonpublic information restricts liability. The approach presents special problems when there is no prior relationship between the parties to a transaction on which to base a duty to disclose. Cases involving outsiders trading on market information, such as *Chiarella*, thus are particularly troublesome. The primary issues are the two issues which were raised in the second section of this Article and which were left open after *Chiarella*: (1) Whether a duty to disclose may rest on a basis other than a relationship between the transacting parties; and (2) whether a theory of liability is permissible under rule 10b-5 which is not premised on any duty to disclose. At least one theory, which has been used since *Chiarella* to impose liability on outsiders for trading on nonpublic market information, may be available after *Dirks*. Several other theories may be adversely affected.

The misappropriation theory, as adopted in *United States v. Newman*,[121] rests not on the breach of a duty to disclose owed to the issuer's shareholders but rather on a fraud on the source of information by virtue of the misuse or "misappropriation" of that information in breach of duties of silence and loyalty to the source.[122] The availability of the *Newman* theory depends upon whether, after *Chiarella* and *Dirks*, liability must be based on a violation of a duty to disclose to those with whom one trades in the marketplace or whether a fraud on a nonpurchase or a nonseller satisfies the requirement of rule 10b-5.

Although the *Chiarella* Court stated that "liability [for nondisclosure] is premised upon a duty to disclose arising from a relationship of trust and confidence between the parties to the transaction,"[123] this lan-

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120. *See* 103 S. Ct. at 3265.

121. 664 F.2d 12 (2d Cir. 1982), *cert. denied*, 104 S. Ct. 193 (1983).

122. *Id.* at 17-18. Although *Newman* does not specifically rest its conclusion on any specific breach of duty, it is clear that duties of "honesty, loyalty and silence" were considered. *Id.* at 16.

123. 445 U.S. at 230. The Court also accepts the notion that insiders owe a duty to disclose to non-shareholders to whom they may sell the issuer's securities despite the absence of a pre-existing fiduciary relationship. *See id.* at 227 n.8 (quoting Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951) (insiders assume fiduciary relation to buyer by

guage is not dispositive of whether a duty to disclose is a necessary basis for liability under rule 10b-5. Because the Court believed that the charge to the jury had only covered the theory that the defendants had breached a duty to disclose to the selling shareholders, it declined to consider a misappropriation theory advanced by the government.[124] The *Dirks* opinion, however, offers new insight into this issue. Near the end of its opinion when the Court applies its insider trading rules to the particular facts before it and negates any argument that Dirks was himself an insider or had a relationship of trust with shareholders or officers of Equity Funding, it states: "Nor did Dirks *misappropriate* or illegally obtain the information about Equity Funding."[125] The Court's apparent need to distinguish such conduct from the facts before it suggests that it views misappropriation as a viable theory of fraud under rule 10b-5.[126]

Justice Stevens in his concurring opinion in *Chiarella* discussed a theory of liability which appears to be based on the approach that misappropriation of confidential information may be a fraud independent of insider trading concepts. He distinguishes between two duties that Chiarella "arguably" breached: "(a) a duty to disclose owed to the sellers . . . and (b) a duty of silence owed to the acquiring companies."[127] Stevens agreed with the majority that a duty to disclose could not be

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virtue of sale)). The Court is thus forced to recognize that the common-law relationship requirement cannot deal with the needs of the securities markets.

124. *See* 445 U.S. at 236 (refusing to consider alternative theory because of lack of jury instruction). In various post-*Chiarella* cases, the SEC has pressed successfully the misappropriation theory. In SEC v. Materia, [Current Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,526 (S.D.N.Y. Sept. 26, 1983), the SEC sued an employee of a financial printer who purchased securities of a takeover target, the identification of which he learned in the course of employment. In an opinion rendered after *Dirks*, the court denied the employee's motion to dismiss. The court held that *Chiarella* did not apply "because there the Court was not presented with the question of the duty owed by a fiduciary, such as [the employee of a financial printer], to the offeror in a tender offer. The prosecution's allegations in *Chiarella* dealt solely with the defendant's duty to the selling shareholders." *Id.* at ¶ 97,027. The court also stated that, "In *Chiarella* the defendant's criminal conviction rested exclusively upon allegations of duties owed to selling shareholders." *Id.* at ¶ 97,028. Judgment was entered in favor of SEC after trial. SEC v. Materia, [Current Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,583 (S.D.N.Y. Dec. 5, 1983). *See also* SEC v. Musella, 578 F. Supp. 425 (S.D.N.Y. 1984) (preliminary injunction against alleged tippees of an office services manager of a law firm who was alleged to have misappropriated information about a tender offer by the firms clients); SEC v. Brant, Civ. 84-3470 (S.D.N.Y. filed May 18, 1984; TRO entered May 19, 1984) (allegation that newspaper reporter misappropriated information about upcoming articles that would affect the market); SEC v. Karanzalis, [Current Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,415 (S.D.N.Y. 1984) (TRO against law firm proofreader based on allegation of misappropriation of tender offer information).

125. 103 S. Ct. at 3267 (emphasis added).

126. *See supra* note 124.

127. 445 U.S. at 237 (Steven, J., concurring).

imposed on Chiarella, but stated that "he unquestionably owed [a duty of silence] to his employer and his employer's customer."[128] Stevens cited the "legitimate argument" that the breach of this latter duty "constituted 'a fraud or deceit' *upon those companies* 'in connection with a purchase or sale of any security.' "[129] He also warned, however, that Chiarella might not be criminally liable because the companies may not be able to recover damages from Chiarella for violating rule 10b-5—they were not purchasers or sellers as required for private rule 10b-5 actions.[130] Saving the theory for another day, Justice Stevens followed the majority and declined to analyze its viability further.[131]

Arguments similar to those underlying Justice Steven's theory were relied upon in *Newman*. The Second Circuit embraced the view that trading on misappropriated information was a fraud on the source of the information in connection with a securities transaction and was actionable under rule 10b-5. In *Newman*, the defendants were indicted for criminal violation of section 10(b) and rule 10b-5. It was charged that Newman and his cohorts traded in securities while possessing nonpublic information that tender offers for those securities were about to be commenced.[132] Several of the defendants were employees of investment banking firms representing the offerors. The theory advanced in the indictment was that the defendants directly and indirectly defrauded the investment banking firms and the firms' clients by trading on information that the employees obtained through their relationships with the investment bankers.[133] The indictment specifically referred to alleged

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128. *Id.* at 238.

129. *Id.* (citations omitted) (emphasis added).

130. *Id*; *see* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731 (1975) (only actual purchasers or sellers of securities can maintain a private damages action under rule 10b-5).

131. 445 U.S. at 237-38 (Stevens, J., concurring).

132. *Newman*, 664 F.2d at 15-16.

133. *Id.* at 15. In several instances, the investment bankers represented the target companies. Presumably the information that the targets had concerning the imminent offers could be seen as inside information of the targets. The government "belatedly" alleged that Newman incurred liability as a tippee of insider information, but the court refused to consider this theory because the allegation was not made within the indictment. *Id.* at 15 n.1. After *Dirks*, some complications are presented by this theory. The employees of the investment banking firms (who tipped Newman) cannot be seen as having obtained information from an insider of the target corporations in breach of a duty, because those corporations retained the investment banking firms, presumably for the purpose of assisting negotiations with the acquiring corporations. Thus, there can be no tippee duty to disclose owed by the employees of the firms; after *Dirks*, the duty must be derived from an insider's breach. The investment bankers can be seen as having "become" insiders within the language in *Dirks* that "[u]nder certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders." 103 S. Ct. at 3261 n.14. *See infra* text accompanying notes 181-85.

duties of "honesty, loyalty and silence" that the employees owed to the investment bankers.[134]

The Second Circuit, reversing the district court's dismissal,[135] relied upon the language of rule 10b-5 prohibiting any practice which operates as a fraud or deceit upon "any person."[136] The circuit court concluded that the misappropriation of information by Newman and the employees of the investment bankers caused a "fraud or deceit" under rule 10b-5 to be worked upon those firms and their clients, the acquiring corporations by "sullying" the reputations of the investment bankers "as safe repositories of client confidences," and possibly artifically inflating the market price of the securities of the takeover targets, thus rendering the tender offer price proposed by the clients of the investment bankers less attractive.[137] The court did not rely on the breach of a duty to disclose but simply noted that in other areas of the law, "deceitful misappropriation of confidential information by a fiduciary" is considered unlawful or fraudulent.[138]

The court thus treated the defendants' conduct as effecting a fraud that was quite distinct from the normal concept of trading on nonpublic information. Misappropriation is not a fraud on the other party to a securities transaction, but on the source of confidential information. This approach departs from the need to find a duty to disclose to the shareholders with whom one trades, by focusing on the nature of the conduct as it affects the interests of the *source* of the information.[139]

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134. 644 F.2d at 16.

135. The district court's opinion is unreported.

136. See *supra* note 3 for the text of rule 10b-5.

137. 664 F.2d at 17.

138. *Id.* at 18.

139. The breadth of an approach that focuses on protecting legitimate interests of the source suggests that the more difficult question is whether a theory of liability under rule 10b-5 that is based on a breach of any duty other than a duty to disclose to a trading partner can fulfill the express requirement of section 10(b) and rule 10b-5 that the conduct be "in connection with purchase or sale" of a security. *See supra* notes 2, 3. The courts have usually followed Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6 (1971). There, the Court construed the "in connection with" requirement to include deceptive practices merely "touching" the sale of securities. *Id.* at 12-13. A relationship which has been described as "very tenuous indeed." *See* 2 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD § 4.7(574)(3), at 88.34 (1979).

For example, in SEC v. General Refractories Co., 400 F. Supp. 1248, 1257 (D.D.C. 1975), the court found the "in connection with" standard met simply by the presence of trading in the public securities markets at the time of the fraudulent acts. *But cf.* SEC v. Box, No. CA-3-80-1217D (N.D. Tex. Sept. 9, 1981), *rev'd*, 721 F.2d 134 (5th Cir. 1983), the court found, on a motion to dismiss for failure to state a claim, that the mere fact that trading occurred in the marketplace contemporaneously with the defendant's undisclosed kick-back scheme was not sufficient to satisfy the "in connection with" requirement of section 10b-5. The district court rejected the reasoning of *General Refractories* and relied upon Alley v.

A possible objection to the theory that misappropriation of infor-

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Miramon, 614 F.2d 1372, 1378 n.1 (5th Cir. 1980), in which the court required "a nexus between the defendant's fraud and the plaintiff's sale of securities." The Fifth Circuit reversed because the allegations were not limited to trading by public investors only and the court could not say that under no set of facts could the SEC prove a violation. *See also* Chemical Bank v. Arthur Anderson & Co., 726 F.2d 930, 943-45 (2d Cir. 1984) (alleged fraud by auditor in failing to audit financial statements of parent did not relate to value of subsidiary which was pledged to plaintiff banks); O'Brien v. Continental Illinois Nat'l Bank & Trust Co., 593 F.2d 55 (7th Cir. 1979) (affirming dismissal against trustee of discretionary trading account because no investment decision was effected by alleged nondisclosure).

The Supreme Court's recent decision in United States v. Naftalin, 441 U.S. 768 (1979), may well assist in resolving the issue of the breadth of the "in connection with" requirement of section 10(b) and rule 10b-5. In *Naftalin*, the Court reversed a holding of the Eighth Circuit that for the government to sustain a criminal action under section 17(a) of the Securities Act it "must prove some impact of the scheme on an investor." United States v. Naftalin, 579 F.2d 444, 448 (8th Cir. 1978) (citations omitted). Section 17(a) of the Securities Act is tracked almost precisely by rule 10b-5, but it prohibits only frauds "in the offer or sale of any security." 15 U.S.C. § 77q(a) (1983). This latter language seems, if anything, more restrictive than the "in connection with" requirement of section 10(b) and rule 10b-5. *See generally Section 17(a) of the Securities Act of 1933 After* Naftalin *and* Redington, 68 GA. L. REV. 163 (1979) (discussing effect of two cases on scope of section 17(a)).

The Eighth Circuit's holding in *Naftalin* was based on its assumption that the "fundamental purpose" of the Securities Act "was to protect *investors* from fraudulent practices in the sale of securities." 579 F.2d at 447 (citation omitted) (emphasis added). Naftalin's scheme involved ordering the sale of securities for his account which he did not own ("short selling"). He hoped that the market price of the shares would decline before he would be required to deliver them to his broker for delivery to the purchaser, so that he could actually purchase the shares to be delivered with the proceeds from the sale, at a profit. When the market price of the shares rose, Naftalin defaulted on delivery and the broker was required to expend its own money to buy the securities for delivery, incurring large losses. *See* 17 C.F.R. § 240.10a-2(a) (1983) (requiring a broker, under certain circumstances, to buy shares which it sold for customer who defaults on delivery of shares). Thus, in *Naftalin*, no investor, rather a broker, acting as agent, was harmed. 579 F.2d at 447.

The Supreme Court reversed the Eighth Circuit's dismissal, refusing to read the language in section 17(a)(3), which forbids conduct that operates as a fraud only "upon the purchaser" into the other two paragraphs of section 17(a), which closely parallel rule 10b-5(a), (b). The Court said: "The statutory language does not require that the victim of the fraud be an investor—only that the fraud occur 'in' an offer or sale." 441 U.S. at 772. Referring to the enactment of the entire panoply of federal securities laws, the Court stated that investor protection was not the sole purpose of the federal securities legislation, and that equally important was "the effort 'to achieve a high standard of business ethics . . . *in every facet of the securities industry*.'" *Id.* at 775 (emphasis added by the Supreme Court) (quoting SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963)). Indeed, the Court noted that Naftalin's conduct, and implicitly any fraud affecting a specific facet of the securities industry, ultimately may hurt investors by, for example, inflicting losses or insolvency on brokers, thereby resulting in higher fees or losses being passed on to investors, or harming investors by virtue of the price and volume impact and market uncertainty that results from schemes such as Naftalin's. 441 U.S. at 776-77. The conclusion of *Naftalin* is easily applied to the seemingly broader "in connection with" language of section 10(b) of the Exchange Act.

A more appropriate test may be whether the misconduct touches or has the potential to affect a securities transaction or some aspect of the investment process or the proper functioning of the securities markets. The District Court for the Southern District of New York, subsequent to *Dirks*, has accepted the *Newman* misappropriation theory without questioning

mation itself violates rule 10b-5 is that the only deception that may be involved in a misappropriation is a failure to disclose the breach (of loyalty or silence) to the person from whom the information is misappropriated.[140] In *Santa Fe Industries, Inc. v. Green*,[141] the Supreme Court held that not every breach of a fiduciary duty is actionable under rule 10b-5; some element of manipulation or deception must be present.[142] Commentators have suggested that this requires an "inducement" or a "trick," suggestive of the common-law element of reliance,[143] although that element has long been removed as an obstacle to establishing a violation of rule 10b-5 in cases of nondisclosure.[144] To adopt the *Newman* theory may be tantamount to making an undisclosed breach of a fiduciary duty actionable under rule 10b-5.

Various lower courts have seized upon a footnote in the *Santa Fe* opinion to hold that an undisclosed breach of a fiduciary duty upon which shareholders could have acted (*e.g.*, by seeking redress in state court) satisfies the deception requirement.[145] The *Santa Fe* Court itself speaks in terms of "nondisclosure" by a fiduciary as concomittant with deception.[146] One commentator has suggested that the only deception in any "insider trading" case involving an open market transaction is a failure to disclose the misuse of the information.[147]

In *Chiarella*, the Court did not discuss the source of "deception" in cases of trading on nonpublic information,[148] but in *Dirks*, there is specific language which suggests that an undisclosed breach of a fiduciary

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the "in connection with" requirement. *See* cases cited *supra* note 124. *But see Newman*, 664 F.2d at 20-21 (Dumbald, J., dissenting in part) (rejecting misappropriation theory because of trend "to confine the scope of § 10(b) to practices harmful to participants in actual purchase-sale transactions").

140. *See, e.g.*, Langevoort, *supra* note 9, at 46-47; Wang, *Post-*Chiarella *Developments in Rule 10b-5*, 15 REV. SEC. REG. 956, 959-60 (1982).

141. 430 U.S. 462 (1977).

142. *Id.* at 473-74.

143. *See, e.g.*, Langevoort, *supra* note 9, at 46-47.

144. Affiliated Ute Citizens v. United States, 406 U.S. 128, 152-54 (1972) (reliance not required in case of nondisclosure).

145. That reasoning has been an important avenue into the federal courts in suits involving allegations against corporations, their officers, and directors for failing to disclose material facts in proxies, tender offer materials, or other disclosure documents. *See, e.g.*, Goldberg v. Merider, 567 F.2d 209, 215-18 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978). *See generally* Sommer, *The Progeny of* Santa Fe *or the Beat Goes On: Efforts to Circumvent* Santa Fe, 2 FOURTEENTH ANN. INST. ON SEC. REG. 26 (1982) (discussing cases that attempt to avoid limits of *Santa Fe*); Ferrara & Steinberg, *supra* note 139, *passim* (discussing scope of rule 10b-5 liability after *Santa Fe*).

146. *See* 430 U.S. at 471, 474 n.14.

147. Langevoort, *supra* note 9, at 7-9.

148. The *Chiarella* Court merely cited *Santa Fe* for the proposition that "not every instance of financial unfairness constitutes fraudulent activity under § 10(b)." 445 U.S. at 232.

duty which results in a profit to the violator is sufficient to constitute a deceptive practice under rule 10b-5. After noting that a duty to disclose under section 10(b) arises from a "fiduciary relationship," the *Dirks* Court warns that under *Santa Fe*, "[n]ot 'all breaches of fiduciary duty in connection with a securities transaction,' come within the ambit of rule 10b-5."[149] But the Court continues:

> There must also be "manipulation or deception." In an inside-trading case this fraud derives from the "*inherent unfairness* involved where one takes advantage" of "information intended to be available only for a corporate purpose and not for the personal benefit of *anyone*." Thus, an insider will be liable under rule 10b-5 for inside trading *only where he fails to disclose material nonpublic information before trading on it and thus makes "secret profits*."[150]

If the "inherent unfairness" of trading without disclosure and making "secret profits" is sufficient deception to invoke rule 10b-5 then the misappropriation theory should be unobjectionable.[151] Of course, in a normal insider trading case, the insider is specifically breaching a duty to disclose to shareholders. Still, when an employee or agent misappropriates information, the agent's duties of silence and loyalty would seem to provide sufficient bases for establishing a constructive deception if the employee was entrusted with information in reliance on those duties and he utilized it to obtain "secret profits."[152]

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149. 103 S. Ct. at 3261.

150. *Id.* (emphasis added) (citation omitted).

151. *Id.* This conclusion is further evidenced when, in defining when an insider breaches his duty in tipping, the Court discusses the scienter issue, noted earlier above, and observes: "But to determine whether the [tipping] itself 'deceive[s], manipulate[s], or defraud[s]' shareholders, [citing *Aaron*], the initial inquiry is whether there has been a breach of duty by the insider." *Id.* at 3265-66. In a footnote, initially concerning the scienter issue, the Court expands on this, noting that the issue in the *Dirks* case is "whether there was any deceptive or fraudulent conduct at all, *i.e., whether [the insider's] disclosure constituted a breach of his fiduciary duty* and thereby caused injury to shareholders." *Id.* at 3266 n.23 (emphasis added). Once again, the Court seems to endorse the idea that an undisclosed breach of fiduciary duty is deceptive. It seems that it would require a smaller step to conclude that the misappropriation of confidential information by a fiduciary for purpose of making "secret profits" is deceptive and, therefore, violates rule 10b-5. Indeed, some active concealment of the conduct seems inherent in the notion of realizing "secret" profits, i.e., there is some element of self-dealing even though the defendant may not be strictly a fiduciary. In this sense, misappropriation may differ from the mere breach of a fiduciary duty involved in corporate mismanagement or other situations of simple unfairness.

152. *See* Langevoort, *supra* note 25, at 1264-66. He notes that courts generally state that a conviction under the federal mail fraud statute cannot be based solely on a breach of fiduciary duty and that some "active fraud" or "deception" is required, but "have by and large accepted the notion that secretive fiduciary misconduct, at least to the extent it 'corruptly' benefits the defendant, is the equivalent of an active fraud." *Id.* at 1264. The courts gener-

Moreover, apart from any notion of constructive fraud which may justify bringing misappropriation within section 10(b),[153] the policies underlying the anti-fraud provisions of the federal securities laws are broader than common-law fraud doctrines. The overriding concern for market integrity expressed in the Exchange Act justifies viewing trading on information which is misappropriated in violation of fiduciary-type duties as "manipulative or deceptive" under section 10(b). The investment bankers and the tender offerors in *Newman* suffered no small injury in the market process in which they were engaged. Just as clearly, the danger for market confidence in that important process was vitiated.

The *Newman* misappropriation theory is not inconsistent with the general principles of tippee liability in *Dirks*. Although all trading on confidential inside information by insiders and improper tipping of inside information to outsiders is, in some sense, a misappropriation of information, there is little danger that the *Dirks* test will be circumvented by reference to the misappropriation theory. For example, if an insider passes information to an analyst without a breach of the insider's duty to shareholders, (*e.g.*, for the express purposes of publication of an article about the issuer), and the analyst trades under circumstances in which the insider receives no benefit, liability cannot attach under *Dirks*. To hold the analyst liable for misappropriating the information to his own purpose—even if the insider warned him not to trade on the information until it was disseminated through the article—would require imposing on the analyst a duty to the corporation. At common law and under the *Dirks* standards, as will be seen below, the analyst probably has not incurred a duty of silence to the corporation. For present purposes, it is sufficient to note that a relationship sufficient to raise a duty of silence for purposes of the misappropriation theory would probably not be found in the usual insider-analyst relationship.[154] This will probably be true although it is arguable that a lesser degree of trust or confidence should be sufficient to impose a duty of silence on an outsider

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ally rely on United States v. Procter & Gamble Co., 47 F. Supp. 676 (D. Mass. 1942), which states that "[t]he actual deception that is practised is in the continued representation of the employee to the employer that he is honest and loyal to the employer's interests." *Id.* at 678, *quoted in* Langevoort, *supra* note 25, at 1264. This reasoning applies equally well to the *Newman* misappropriation theory, and should surmount the obstacles of *Santa Fe*, even if that case requires "active" fraud or deception.

153. *See* Langevoort, *supra* note 25, at 1253. "Seizing on the secretive nature of a fiduciary breach and its violation of expectations, many courts simply have concluded that any breach of fiduciary duty is a constructive fraud . . . ." *Id.* (footnote omitted). But he believes that because of the concern in *Santa Fe* that federal law not supplant the various existing and presumably adequate state remedies for breach of fiduciary duties, *Santa Fe* requires "active fraud." *Id.* at 1268-72.

154. *See* 103 S. Ct. at 3261 n.14; *supra* text accompanying note 139.

than is necessary to create the affirmative, fiduciary duty to disclose to shareholders. Because the *Newman* misappropriation theory presents no danger to the common-law duty approach of *Chiarella* and *Dirks*, and because it provides a means to outlaw conduct clearly harmful to interests protected by the federal securities laws, it should be accepted as within the scope of section 10(b).

Chief Justice Burger advanced a similar theory of misappropriation in his dissent in *Chiarella*.[155] His theory, however, was based not on a fraud on the source, but as with traditional insider trading, on a fraud on the other party to the transaction. He posited that misappropriating information automatically creates a duty to disclose to persons with whom the misappropriator trades. This duty presumably is imposed by operation of law, rather than as a result of some special relationship between the misappropriator and his victims or a breach of duty to the source from whom he gains the information.[156] A modified version of the Chief Justice's theory is that a duty to disclose to those with whom one trades arises from breach of duties to the source by virtue of the misappropriation. The availablity of the Burger theory, or its corollary theory, depends upon whether *Dirks* and *Chiarella* require that the duty to disclose arise only from a relationship between parties to a transaction.

The *Dirks* opinion seems to foreclose Burger's notion of a duty to disclose arising as a legal consequence of a misappropriation of information: " 'Because the disclose-or-refrain duty is extraordinary, it attaches *only when a party has legal obligations other than a mere duty to comply with the general antifraud proscriptions in the federal securities laws*.' We reaffirm today that '[a] duty [to disclose] arises from the relationship between parties . . . .' "[157]Although facially contrary to Chief Justice Burger's theory, this language still would leave room for the corollary theory: that a duty to persons in the marketplace to disclose market information arises from the relationship, or breach of trust, between a trading misappropriator

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155. 445 U.S. at 239-45 (Burger, C.J., dissenting).

156. *Id.* at 240. ("I would read § 10(b) and Rule 10b-5 to encompass and build on this principle: to mean that a person who has misappropriated non-public information has an absolute duty to disclose that information or to refrain from trading.") The Chief Justice believed that the jury was adequately charged with the theory that Chiarella "unlawfully converted" information. *See id* at 243-45. Although there may be some notion of breach of duty in this concept of "misappropriation," Burger does not appear to require that the misappropriation be in breach of a duty other than a general duty not to steal. "[T]he [fiduciary] rule should give way when an informational advantage is obtained . . . by *some unlawful means*." *Id.* (emphasis added). Thus Burger's theory is more expansive because it potentially would cover theft. To the extent Burger would outlaw theft of nonpublic information by imposing a duty to disclose upon the thief, his view conflicts with *Dirks*. *See infra* note 171.

157. 103 S. Ct. at 3262-63 (emphasis added) (citation omitted).

and the source of the information. But that postulate is inconsistent with the *Chiarella* Court's view of a duty to disclose as based on common-law concepts of fraud, which require that a duty to disclose facts material to a transaction arise not from any relationship, but from a relationship between the two parties to the transaction.[158]

Other language in *Chiarella* and *Dirks* confirms this reasoning. In *Chiarella*, the Court specifically stated that a duty to disclose for purposes of section 10(b) liability arises "from a relationship of trust and confidence between parties to a transaction."[159] In *Dirks*, referring to *Chiarella*, the Court noted that the "requirement of a specific relationship *between the shareholders and the individual trading on inside information* has created analytical difficulties for the SEC [in tippee cases]."[160]

In *Moss v. Morgan Stanley, Inc.*,[161] a private class action against the defendants in *Newman*, which was decided after *Dirks*, the Second Circuit confirmed the view that a duty to disclose must arise from a relationship between the transacting parties, and explicitly rejected both Burger's theory and the theory that a duty to disclose to those with whom one trades might arise from a breach of trust to another party through the misappropriation of confidential information. The plaintiffs in *Moss* were sellers of the stock of a takeover target that had been evaluated by Morgan Stanley & Co. while investment advisors to the acquiring company. Prior to the tender offer, an employee of Morgan Stanley revealed the tender offer plans to one Antoniu who in turn told Newman, a stockbroker. The three (the employee, Antoniu, and Newman) then purchased securities of the target which they sold for a substantial profit after announcement of the tender offer. The plaintiffs sued Newman and his two cohorts for violation of rule 10b-5 and Morgan Stanley for failing to supervise its employee. The district court, writing prior to *Dirks*, had dismissed the complaint for failure to state a claim.[162] The Second Circuit, relying on *Chiarella*, quickly disposed of the main issue:

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158. *See* 445 U.S. at 228; *supra* text accompanying notes 31, 32; *see also, e.g.*, Laventhal v. General Dynamics Corp., 704 F.2d 407, 411-12 (8th Cir. 1983) (emphasizing need for relationship between the trading parties). The Chief Justice did not rest his theory on any specific relationship, and in fact specifically rejected the Court's suggestion "that only 'a relationship between petitioner and the seller . . . could give rise to a duty [to disclose].'" 445 U.S.. at 243 n.4. *See supra* note 35.

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

160. 103 S.Ct. at 3261 (emphasis added).

161. 719 F.2d 5 (2d Cir. 1983).

162. 553 F. Supp. 1347, 1364 (S.D.N.Y.), *aff'd*, 719 F.2d 523 (2d Cir. 1983). Plaintiff's claim under the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-68 (1982) was also dismissed.

> Absent an "insider" or "fiduciary" relationship *with the sellers of stock*, a purchaser has no duty to disclose nonpublic market information.
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> * * * *
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> In applying *Chiarella's* "fiduciary standard" to this case [the district court] concluded that [the defendants] owed no "duty to disclose" to plaintiff Moss and hence could not be liable for a section 10(b) or rule 10b-5 violation . . . . We agree.[163]

The circuit court then rejected Burger's theory, that a misappropriation creates a general duty of disclosure, on the ground that it was contradicted by both *Chiarella* and *Dirks*.[164] It similarly rejected the corallary theory, stating, in the district court's words, " 'plaintiff cannot hope to piggyback upon the duty owed by defendants to Morgan Stanley and [its client].' "[165] These holdings were both based on the Supreme Court's reference to the common-law principle that a duty to disclose can arise only from a relationship between the parties to a transaction.[166]

Despite this rejection, Burger's misappropriation theory may yet be reconciled with the *Dirks* opinion. Dissenting in *Chiarella*, the Chief Justice stated that basing a duty to disclose on the misappropriation of information "follows naturally from legal principles [access and unfairness] enunciated . . . in [the SEC's] seminal *Cady, Roberts* decision."[167] Moreover, the Chief Justice seems to have relied on more than the unfairness of trading on nonpublic information that is the result of mere access, stating that "[b]oth of these factors are present whenever a

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163. 719 F.2d at 12-13 (citation omitted).

164. *Id.* at 16.

165. *Id.* at 13 (quoting 553 F. Supp. at 1353).

166. *Id.* at 13, 16. The rejection in *Moss* of Chief Justice Burger's misappropriation theory creates the somewhat anomolous result of subjecting traders such as Newman to criminal prosecution under the federal securities laws but denying any remedy to traders proximately injured by their misconduct. The same court which had dismissed the complaint in *Moss* had previously reached the opposite result on the ground that *Chiarella* did not change the section 10(b) standing requirement for a private action, i.e., that the plaintiff be a purchaser or seller of a security. O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179, 1186 (S.D.N.Y. 1981); *see* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)(standing under § 10(b) requires the plaintiff to be a purchaser or seller of securities).

In *O'Conner* the court accepted that even an insider of an issuer did not owe any duty to disclose to a trader in standardized options for the issuer's securities, because the options trader is not a shareholder of the issuer. Nevertheless, the court felt that since a fraudulent practice under the *Newman* theory was alleged, and the plaintiffs, as sellers of a security, were "within the scope of the statute's and the rule's intended beneficiaries" and had alleged "direct injury" as a result of the fraudulent practices, they had standing to sue. 529 F. Supp. at 1186. The result is in direct conflict with the *Moss* decision.

167. 445 U.S. at 241.

party gains an informational advantage by *unlawful* means."[168] Requiring some breach of a legal obligation is consistent with the *Dirks* rejection of the parity rule and the manner in which the Court treats tippees—requiring, in effect, "participation" in a breach of an insider's duty. Despite this apparent parallel, any "unfairness" concept in *Dirks* must be read to mean that it is unfair to allow a person to take advantage of those with whom he is in a fiduciary relationship, i.e., shareholders of his corporation,[169] and not simply that it is unfair to allow one to take advantage of information obtained by unlawful means.

Nevertheless, the Court's explicit reference to the fact that Dirks did not "misappropriate or *illegally obtain* the information" at issue[170] leaves open the possibility that the illegally obtained information is always tainted under section 10(b) and rule 10b-5.[171] Indeed, Burger accepted the basic premise in *Chiarella* that in an arms-length transaction there is no duty to disclose "unless the parties stand in some confidential or fiduciary relationship."[172] But he continued, "the policies that underlie the rule also should limit its scope. In particular, the rule should give way when an informational advantage is obtained, not by superior experience, foresight or industry, but by some unlawful means."[173] Such an exception to the common-law rules of liability adopted in *Chiarella* would not be inconsistent with *Dirks*. Analysts would still be

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168. *Id.* at 241-42 (emphasis added). Though Burger quoted the same language from *Cady, Roberts* as did the *Dirks* Court, *see supra* text accompanying note 57, he omits the limitation to inside information and insiders.

169. *See supra* text accompanying notes 54-56.

170. 103 S. Ct. at 2367 (emphasis added).

171. The Chief Justice joined the majority in overturning the SEC's censure of Dirks. Burger did not rest his theory in *Chiarella* on the existence of a special relationship, and in *Dirks*, the Chief Justice did not add any thoughts about the theory. It seems unlikely that he would join an opinion that could be read to conflict with his own views without a clarifying concurrence. There is some authority for the proposition that the court would treat Burger's misappropriation theory as a necessary adjunct to its relationship-based insider trading rules. Commissioner Smith, concurring separately in *Investors Management Co.*, 40 S.E.C. at 650 n.2, advanced a rule of tippee liability based on a breach of duty by the tipping insider but noted that his rule would cover situations of theft or discovery of a lost document containing obviously confidential information because "[a] duty not to steal or knowingly receive stolen goods or exercise discretion over goods known to be owned by others exists toward the corporation even without the presence of a special relationship." The *Dirks* Court specifically embraced Commissioner Smith's reasoning concerning tippee liability arising from an insider's breach, *see* 103 S. Ct. at 3265, and perhaps would also adopt his views concerning at least theft of confidential information. Note that Commissioner Smith's view that theft violates a duty to *the corporation* differs from the Chief Justice's view that misappropriation creates a duty to disclose to *the marketplace*. The former theory could be used to impose liability in actions under section 10(b) brought by the SEC or Justice Department, but the latter would allow private actions. *See supra* note 166.

172. *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting).

173. *Id.* at 240.

allowed to utilize information received from insiders absent a presumably "unlawful" breach of the insider's duty to shareholders, and the mere possession of nonpublic information would not create a duty to disclose. The better view would be to allow an exception to the Court's strict reference to common-law fraud and fiduciary duty standards to outlaw the use of "unlawfully" obtained inside or market information—whether or not a fiduciary duty is breached.

B. Effect on Cases Involving Insiders Trading on Market Information

The *Dirks* Court's reliance on the common law and its restriction of the *Cady, Roberts* standards could allow insiders to trade with shareholders with whom they have a fiduciary relationship without disclosing material *market* information. *Chiarella* did not resolve whether an *insider* who trades in his company's securities while possessing market information concerning those securities has violated rule 10b-5.[174] But the *Dirks* Court emphasized that the unfairness that the *Cady, Roberts* rules were designed to prohibit is the unfairness of *insiders* taking advantage of "*inside* information intended only to be available for a corporate purpose."[175] If the standard is limited in this manner, insiders will not be prohibited from trading with their shareholders while in possession of undisclosed market information.

Information coming from a bidder concerning a planned tender offer or from an outsider concerning a favorable contract about to be awarded to the insider's corporation are classic examples of market information. Commentators writing shortly after *Cady, Roberts* expressed the view that liability should be imposed in these situations, at least if the information was communicated to the insider during negotiations between the two corporations.[176] Because the insider is a fiduciary to his shareholders, it seems that he should not be allowed to trade with them without disclosing material information concerning the value of their stock regardless of the source of the information. He gains no less of an

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174. 445 U.S. at 231-33.

175. 103 S. Ct. at 3260 (emphasis added). Although the Court did not distinguish inside and market information or any legal basis, to the extent that these general principles are applicable to all cases of trading on nonpublic information, *Dirks* may suggest that the entire body of information not emanating from corporate sources is outside the proscription of rule 10b-5. *See, e.g.*, Xaphes v. Shearson, Hayden, Stone, Inc., 508 F. Supp. 882, 886 (S.D. Fla. 1981) (plaintiff not liable for nondisclosure because securities laws do not require disclosure of non-inside information).

176. *See supra* note 55; *see also* SEC v. Reed, No. 81-7984 (S.D.N.Y. Dec. 23, 1981) (consent to injunction by outsiders who allegedly learned of potential tender offer from persons associated with the target); SEC v. Fin America Corp., No. 81-0553 (D.D.C. Mar. 9, 1981) (consent to injunction by insider who purchased without disclosing agreement to sell at premium).

unfair advantage over his stockholders if he trades on market information about a proposed tender offer, than if he trades on inside information concerning an unannounced dividend.

The reasoning of *Affiliated Ute Citizens v. United States*,[177] supports imposing liability under rule 10b-5 on insiders for trading on market information. In *Affiliated Ute Citizens*, the defendant bank had been designated transfer agent for a corporation that was formed to manage tribal holdings of certain Native Americans. Several of the bank's assistant managers helped the shareholders to sell their stock outside of the Native American community by actively soliciting and accepting standing orders from persons outside the community.[178] The plaintiffs charged, among other things, that they were defrauded when these assistant managers failed to disclose the existence of higher prices for the shares in a resale market consisting of non-Native Americans. The Court found that the bank's employees acted as market makers on whom the Native American sellers relied, and therefore imposed a duty upon the bank's assistant managers to disclose the existence of the more favorable market to the Native American sellers.[179] *Affiliated Ute Citizens* thus stands as a case wherein persons with "special relationships" to those with whom they dealt were held liable under section 10(b) for failure to disclose material, *market* information. But *Affiliated Ute Citizens* is distinguishable from the usual case of an insider dealing with shareholders in an impersonal market to the extent that there was personal contact with and apparent reliance on the bank's employees.[180]

If the Supreme Court adheres to the rationale that a special relationship creates a duty to disclose, then insiders should not be allowed to take advantage of shareholders by trading on nonpublic information concerning their securities, no matter the source of that information. But if the Court sees its reasoning as limited to situations where an insider takes advantage of information "intended to be available only for a corporate purpose" of the issuer of which he is an insider, a contrary result is possible.

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177. 406 U.S. 128 (1972).

178. *Id.* at 145-47, 152.

179. *Id.* at 152-53. This comports with the *Dirks* Court's refusal to distinguish between insider and market information for section 10(b) purposes.

180. The Court could distinguish *Affiliated Ute Citizens* on the ground that there was personal contact between the Native Americans and the bank's assistant managers. 406 U.S. at 140, 148-49. *Cf. Chiarella*, 445 U.S. at 230 (reading *Affiliated Ute Citizens* as holding that the managers could not "act as market makers *inducing* [the sales] without disclosing the existence of the more favorable non-Indian market.") (emphasis added).

C. *Ancillary Effects on Notions of Assumption of Duty: Outsiders Trading on Inside Information*

Dirks creates potentially unmanageable difficulites for corporate confidentiality in the common situation in which outside advisers and consultants are given access to confidential information for limited business purposes of the issuer. The nature of the relationship required to impose a fiduciary duty to disclose on outsiders was an open question after *Chiarella*.[181] Cases prior to *Chiarella* held that any relationship which resulted in access to inside information imposed a duty to disclose upon the recipient.[182] Thus, lawyers, underwriters and other consultants, and even "close friends" of the officers of a corporation could be found to have violated a fiduciary duty to shareholders if they traded while in possession of information that the issuer revealed to them in confidence.[183]

Although the *Dirks* Court severely restricted the *Cady, Roberts* notion of "access" as the basis for a duty to disclose, in a footnote it outlines the circumstances in which an "outsider" may acquire the duty of an insider in the absence of an insider's breach of fiduciary duty. The Court does not speak in terms of "assumption of duty," but rather notes that " '[u]nder certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer or consultant working for the corporation, these outsiders may become fiduciaries.' "[184] The idea of "becoming" a fiduciary bespeaks the rigidity with which the Court outlines the circumstances which permit such a transformation. To accommodate the concept of "becoming" a fiduciary—or more accurately "assuming" the role of a fiduciary—and still to allow room for its standard for tippee liability, the Court must tightly circumscribe the circumstances under which one is transformed into a fiduciary:

> The basis for recognizing this fiduciary duty is not simply that such persons acquired non-public corporate information, but rather that they have entered into a special confidential relationship *in the conduct of the business of the enterprise* and are given access to information solely for corporate purposes.[185]

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181. *See supra* text accompanying notes 28-40.

182. *See, e.g.*, Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 796 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970) (reliance on access, and other factors, to find insider status); Ross v. Licht, 263 F. Supp. 395, 409-10 (S.D.N.Y. 1967) (friends of insiders treated as insiders because of access to information).

183. SEC v. Shapiro, 494 F.2d 1301 (2d Cir. 1974) (merger brokers deemed insiders); Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967).

184. 103 S. Ct. at 3261 n.14.

185. *Id.*

Thus, the "access" test of *Cady, Roberts*, absent a breach of duty by an insider in passing the information, becomes a requirement that a person enter into a special relationship with the corporation itself to such an extent that the two can be considered engaged in a common enterprise. The Court warns that the corporation must "expect the outsider to keep the . . . information confidential."[186] And finally the exception must be objectively justifiable—that is, "the relationship at least must imply such a duty."[187]

The significance of that latter caveat is soon evident, as the Court apparently endorses the Second Circuit's decision in *Walton v. Morgan Stanley & Co.*.[188] In that case, an investment banker was engaged by a corporate client seeking to acquire a second corporation, and the second corporation revealed certain inside information to induce a friendly acquisition. After the proposed tender offer fell through, the investment banker traded based on the information it had acquired during its discussions with the potential target. Shareholders of the potential target sued, charging a violation of state law in trading on the nonpublic information.[189] The circuit court held that state law did not foreclose the investment banker from purchasing shares of the target based on the acquired information, because the discussions created no common-law fiduciary duty.[190] The court's determination rested on its finding that the information was passed during "arm's-length negotiations," despite the request by the potential target that the information remain confidential.[191] The court also felt that the parties were able to forsee the problem and could have resolved it by a formal confidentiality agreement—little comfort to those shareholders who traded with the better informed investment bankers.[192] Thus, despite a clear expectation that the information remain confidential, the Court refused to impose a duty on Morgan Stanley because the formal relationships between it and the issuer did not justify it.

The *Dirks* Court adopts and formalizes the rationale of *Walton* when it states that for an outsider to take on a fiduciary's duty of disclosure, the corporation must not only demand or expect confidentiality, but in addition "the relationship must . . . imply such a duty."[193] The Court thus rejects any notion of assumption of duties by operation of

186. *Id.* (emphasis added).
187. *Id.*
188. 623 F.2d 796 (2d Cir. 1980).
189. *Id.* at 797-98.
190. *Id.* at 799.
191. *Id.* at 798.
192. *Id.* at 799.
193. 103 S. Ct. at 3261 n.14.

law or by the knowing receipt of information even for an acknowledged, limited, corporate purpose. Instead, the creation of fiduciary duties must be firmly based in facts which effectively place the outsider in the constructive employ of the corporation.

One post-*Dirks* opinion has potentially expanded the concept of "becoming" an insider. In *SEC v. Lund*,[194] it was alleged that Lund, president and chairman of the board of Verit Industries (Verit) violated rule 10b-5 when he purchased shares of P&F Industries, Inc. (P&F) while in possession of nonpublic information concerning a proposed joint venture between P&F and another party.[195] The chairman, chief executive officer, and president of P&F, Horowitz, who was a long-time friend of Lund, had proposed to Lund that Verit join the venture.[196] The district court first noted that, after *Dirks*, the SEC correctly abandoned its argument that Lund could be liable as a tippee; Horowitz did not breach any fiduciary duty to P&F or its shareholders by disclosing information to Lund because that disclosure was within the scope of his authority as an officer and director of the company.[197] The Court thus viewed the disclosure as pursuant to a legitimate business purpose of P&F.

Relying on the Supreme Court's discussion in footnote fourteen in *Dirks*, however, the district court found Lund to be a "temporary" insider of P&F and thus imposed liability.[198] The *Lund* court based its finding on the facts that Lund and Horowitz were long-time friends and business associates; they often exchanged information about their companies; Horowtiz was on the board of directors of Verit; Horowitz told Verit, through Lund, of the P&F joint venture because of their special relationship; the information was disclosed solely for a corporate purpose; and Horowitz did not expect Lund to use the information for his own benefit or to make it public.[199]

The court's interpretation of footnote fourteen seems at odds with *Walton* and may not fulfill the strict requirements of footnote fourteen. It seems closer to the access approach of the pre-*Dirks* cases and is not far from saying that whenever close friends exchange business information they become insiders, temporarily, of each other's issuers. The only added element is the finding, albeit an important one under *Dirks*, that the purpose of the disclosure in *Lund* was to invite Verit into the pro-

194. 570 F. Supp. 1397 (1983).
195. *Id.* at 1399.
196. *Id.* at 1400 & n.2.
197. *Id.* at 1402.
198. *Id.* at 1403.
199. *Id.*

posed transaction. Nevertheless, the court seems to expand the *Dirks* concept that one becomes an insider only when involved in a special relationship in the conduct of the enterprise. But, *Lund* is consistent with *Dirks* to the extent that *Dirks* precludes trading by outsiders to whom the issuer reveals information in an *attempt* to interest them in a common enterprise or special relationship. *Lund* is distinguishable from *Walton* because in *Walton* the parties did not contemplate establishing a relationship to assist in the conduct of the target corporation's affairs. The potential target corporation knew that Morgan Stanley was, in fact, working for the potential acquiring corporation, and it was contemplated that the target's relationship with Morgan Stanley would always remain arms-length, even if merger discussions were begun. The *Lund* decision thus can provide an additional basis for imposing a duty to disclose on an outsider who has no preexisting fiduciary relationship with an issuer but who receives nonpublic information concerning the issuer's securities without a breach by an insider.

V. CONCLUSION

In the first part of its opinion, the *Dirks* Court, by general reference to the guiding principles suggested by *Cady, Roberts* and through modification and interpretation of those principles as an endorsement of common-law concepts, refines the requirements of a duty to disclose and announces that those requirements will apply to all cases of trading on nonpublic information. The Court confirms its suggestion in *Chiarella* that such trading violates rule 10b-5 only if a specific relationship between the shareholders and the individual who is trading establishes a duty to disclose. But the Court raises additional questions, especially about the status of trading on nonpublic market information by outsiders and insiders. The Court also limits or, perhaps, eliminates the concept of assuming a duty to disclose by operation of law. Thus, the Court's opinion further restricts those situations in which a duty to disclose may attach to outsiders.

While seemingly endorsing the *Cady, Roberts* rationale, the Supreme Court has all but forgotten the notions of fairness and market integrity underlying that decision—the notions most important for advancing the policies underlying the Exchange Act—and has thereby pulled interpretation of rule 10b-5 closer to the common-law concepts which Congress found were inadequate to protect the unique and complex securities markets. Although the Court complains that the SEC's suggested rule catches too much conduct, the Court's rule places virtually no limits on the analyst-tippee's use—or misuse—of inside information. Once the analyst receives the information without a breach of the insider's duty,

he is free to use it in whatever manner he sees fit; unless of course he independently violates the prohibitions of the securities laws.

The new principles of tippee-liability are based on the Court's perception of a need for freer access to material, nonpublic information and are designed to insure that market prices quickly reflect such information. The Court reaches this conclusion without considering the alternatives available, such as imposing a duty of prompt disclosure on issuers or the creation of a duty to disclose by reference to the justifiable expectations of the marketplace. With little concern for the inevitable "losers" whose trades are sacrificed in the interest of pricing efficiency, the Court's rules refer exclusively to common-law precepts despite the paramount concern of the Exchange Act for the protection of investors and the integrity of the market process.