

Access, Efficiency, and Fairness in *Dirks v. SEC*

INTRODUCTION

Section 10(b) of the 1934 Securities and Exchange Act prohibits insiders from unfairly taking advantage of material, nonpublic information concerning a corporation. In *Dirks v. SEC*,¹ Dirks was a securities analyst who had been tipped by an insider of Equity Funding Corporation of America that the success of the company was due in part to fraud.² Dirks corroborated sources of the information he received by further investigations and disseminated the information to his clients.³ The Supreme Court, reversing the court of appeals, held that "the tippee's duty to abstain or disclose is derivative from that of the insider's duty."⁴ The Court further held that the insider Secrist did not breach his fiduciary duty to the shareholders of Equity Funding because he did not intend to gain personally from the release of the information to Dirks.⁵ Dirks, therefore, was said not to have breached any duty by disclosing the information to his clients.⁶

The *Dirks* decision is the first in which the Court has ruled that a motive of personal gain is necessary to invoke liability under section 10(b) of the 1934 Securities and Exchange Act and rule 10b-5 promulgated thereafter.⁷

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

2. *Id.* at 3258.

3. *Id.*

4. *Id.* at 3262.

5. *Id.* at 3265.

6. *Id.* at 3266.

7. Securities and Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1970). Section 10(b) of the 1934 Act makes it "unlawful for any person . . . (b) to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

SEC rule 10b-5, 17 C.F.R. § 240.10b-5 (1976), promulgated pursuant to the SEC's rule-making authority in 1942, provides:

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

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

(b) To make any untrue statement of a material part 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.

The improper purpose requirement, however, is not the only novel concept articulated in the *Dirks* opinion.⁸ In a footnote destined to have significant impact on later actions,⁹ the majority opinion stated: "Under certain circumstances, such as when corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant, working for the corporation, these outsiders may become a fiduciary of the shareholders."¹⁰ This dictum from *Dirks* has been used in another case to change the status of a trader from an outsider to a "temporary insider."¹¹

The Supreme Court in addition to the "improper purpose" requirement and the "temporary insider" concept, acknowledged and perhaps implicitly confirmed the viability of the misappropriation theory by stating "nor did *Dirks* misappropriate or illegally obtain information about Equity Funding."¹² Though the misappropriation theory had been used successfully in lower court cases before *Dirks*,¹³ the acknowledgement of the theory by the Supreme Court might imply that a majority of the Court could acquiesce to Chief Justice Burger's misappropriation theory and hence give it sustenance in subsequent actions.¹⁴

While the "temporary insider" concept and misappropriation theory should be a boon to SEC enforcement efforts, the "improper purpose" requirement will create a heavier evidentiary burden in any action against a tipper under 10(b) and 10b-5.¹⁵ Combined, these concepts of 10b-5 liability should have an interesting, perhaps offsetting, effect on the number and success of SEC enforcement actions.¹⁶ Because these theories are mentioned in a case that is so different in its facts from earlier cases,¹⁷ they also provide an opportunity to reconcile the results of earlier cases and to evaluate the consistency of different legal and economic theories that have been espoused in the context of securities fraud. This Note focuses on selected legal and economic ar-

8. The majority might not want to consider the improper purpose requirement or the temporary insider theory as novel. However, it did not occur to defendants or plaintiffs, respectively, to argue these theories until after *Dirks*.

9. *Dirks*, 103 S. Ct. at 3261 n.14. A spokesman for the SEC stated that the SEC believed that the *Dirks* opinion would encourage, not inhibit, further SEC actions because of the concept the Court articulated in the footnote. N.Y.L.J., Aug. 18, 1983, at 1 col. 1.

10. *Dirks*, 103 S. Ct. at 3261 n.14.

11. SEC v. Lund, 570 F. Supp. 1397 (C.D. Cal. 1983).

12. *Dirks*, 103 S. Ct. at 3267.

13. See *infra* notes 64-70 and accompanying text.

14. Justices Burger and Brennan espoused the misappropriation (theory?) first in *Chiarella v. United States*, 445 U.S. 222 (1980). Concededly, the Court may have mentioned the misappropriation theory in *Dirks* to persuade Chief Justice Burger to sign the majority opinion. However, it is also probable that Justices Blackmun and Marshall would affirm the misappropriation theory. See 445 U.S. at 232 (Blackmun & Marshall, JJ., dissenting).

15. The SEC argued that a tippee inherited the insider's disclose or refrain duty whenever he knowingly received material non-public information. *Dirks*, 103 S. Ct. at 3261-62. The improper purpose requirement, however, mandates that the tippee must also know that the tip was made improperly.

16. See N.Y.L.J., *supra* note 9.

17. The Supreme Court refers to the facts of *Dirks* as extraordinary. *Dirks*, 103 S. Ct. at 3263, 3268.

guments in an effort to harmonize the results of earlier rulings and help give substance to the nebulous concept of a fiduciary in criminal actions under 10b-5. Section I provides a brief background and prelude to the *Dirks* case, then section II discusses the misappropriation and temporary insider theories, and the personal gain requirement. Section III considers different policy arguments in an effort to give substance to the fiduciary concept and the vaguely defined policies of fairness and market efficiency. In section IV the arguments of selected Justices are discussed in the context of a balancing test that uses the policy arguments from section III. Section V concludes with a brief discussion of the applicability of a balancing test due to competing policy interests.

I. BACKGROUND

A. Common Law

Before the Securities Acts, the plaintiff normally tried to extend the common law tort of misrepresentation to reach nondisclosures of corporate information in transactions involving a corporate official of the issuer.¹⁸ In recognition of the fiduciary relationship existing between shareholders and corporate officers and directors, this rule was expanded in some cases to include a general duty of disclosure on the part of the corporate director or officer when transacting with the shareholders.¹⁹

The fiduciary principle arose from two different but related concepts. First, an actual expectation of fair dealing arising from a relationship of trust and confidence requires the corporate officer to act according to the shareholder's reliance.²⁰ Second, and on a broader basis, a person holding the property or welfare in trust for a beneficiary should exhibit loyalty by acting in the best interest of the beneficiary.²¹ The rationale was offered in

18. *Strong v. Repide*, 213 U.S. 419 (1909), is the seminal case of enforcing the common law tort of misrepresentation in cases of silence between a corporate director and a shareholder. Normally, an affirmative misrepresentation was required, but the Court referred to the civil code's definition of deceit: "When by use of 'words or insidious machinations' one induces another to execute a contract without which he would not have made." The Court's rationale became known as the "special facts" doctrine of imposing a duty of disclosure upon a corporate director. See also, *Oliver v. Oliver*, 118 Ga. 362, 45 S.E. 232 (1903); W. CARY & M. EISENBERG, *CASES AND MATERIALS ON CORPORATIONS* 714-17 (5th ed. 1980); Hill, *The Sale of Controlling Shares*, 70 HARV. L. REV. 986, 1014-18 (1957); Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725, 740-46 (1956).

19. E.g., *Oliver v. Oliver*, 118 Ga. 362, 45 S.E. 232 (1903); *Hotchkiss v. Fischer*, 136 Kan. 530, 16 P.2d 531 (1933). Both of these cases relied on the general rule that affirmative disclosure is required when the parties stand in a fiduciary relationship. See W. PROSSER, *THE LAW OF TORTS* § 106 (4th ed. 1971); *RESTATEMENT (SECOND) OF TORTS* § 551 (1977).

20. E.g., *Hotchkiss v. Fischer*, 136 Kan. 530, 16 P.2d 531 (1933). See also *Langevoort, Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CALIF. L. REV. 1 (1982).

21. See generally *Scott, The Fiduciary Principle*, 37 CALIF. L. REV. 539 (1949). Even when the parties do not trust each other there can still be a fiduciary relationship. See D. DOBBS, *REMEDIES* 681 (1973). The shareholders have little to say in the selection of the fiduciary but are still entitled to the performance of the duties whether they trust the fiduciary or not.

some cases that even when there is no communication between the two parties and the corporate official does not solicit a price offering, the concept of loyalty requires the corporate officer to share his information so as not to gain at the expense of the beneficiary.²²

This fiduciary principle, which was derived from common law trust and misrepresentation concepts,²³ was awkwardly applied to the relationship between the corporate official and the shareholder.²⁴ The concepts of trust and misrepresentation did not identify whether the corporate official owed a duty to the corporation, to the shareholder, or to both.²⁵ Moreover, while the fiduciary principle was tailored for face to face transactions between insiders and shareholders, it was difficult to apply in an institutional, anonymous marketplace like the New York Stock Exchange.²⁶ On the exchange, persons do not know who their buyers are, and because of the independence of buyer and seller decisions, causation and injury are difficult to trace.²⁷ Consequently, the first state court to consider this question rejected the obligation of affirmative disclosure for an insider in a stock exchange transaction.²⁸

B. Expansion Under 10(b) and 10b-5

Early cases under 10(b) and 10b-5 imposed the common law fiduciary duty of disclosure on corporate insiders in face-to-face transactions,²⁹ but

22. See *List v. Fashion Park*, 340 F.2d 457 (2d Cir. 1968); *Bruce v. Rosenberg*, 463 F. Supp. 673 (E.D. Wis. 1979).

23. See generally L. Loss, *SECURITIES REGULATIONS* 1430 (1961).

24. The hornbook elements of deceit are: There must be (1) a false representation of (2) a material (3) fact; (4) the defendant must know of the falsity (scienter) but make the statement nevertheless for the purpose of inducing the plaintiff to rely on it; and (5) the plaintiff must justifiably rely on it and (6) suffer damages as a consequence. *Id.* at 1431.

25. See generally Shulman, *Civil Liability and the Securities Act*, 43 *YALE L.J.* 227 (1933).

26. In a face-to-face transaction the element of inducement is more obvious than on a market exchange.

27. See generally Shulman, *supra* note 25.

28. *Goodwin v. Agassiz*, 283 Mass. 358, 186 N.E. 659 (1933). See generally Comment, *The Prospects for Rule X-10b-5: An Emerging Remedy for Defrauded Investors*, 59 *YALE L.J.* 1120 (1950).

29. *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947); *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951). In *Kardon* both defendants and plaintiffs were directors. Defendants had negotiated a sale of the corporation's assets to outsiders without telling the plaintiffs. The court in deciding upon the applicability of Rule 10b-5 stated that "the broad terms of the Act are to be made effective in a case like the present one through the application of well known and well established equitable principles governing fiduciary relationships." 73 F. Supp. at 803. Furthermore the defendants breached this duty when they "disposed of the bulk of the corporate assets to an outsider, for their own benefit, without disclosing the transaction to the plaintiffs or giving them an opportunity to participate in it." *Id.* at 802. In *Speed*, the plaintiffs claimed that Transamerica, the majority shareholder of Axton-Fisher Tobacco Company, had purchased Axton-Fisher stock from the plaintiffs without disclosing that the value of Axton-Fisher's inventory was far in excess of the amount indicated in its annual report and that Transamerica intended to capture such inventory by merger with, or dissolution of Axton-Fisher. The court held that the defendants violated 10b-5 because they

not until the seminal case of *In re Cady, Roberts & Co.* did the shift of the insider trading doctrine begin.³⁰ In *Cady, Roberts*, a director of Curtiss-Wright Corp. who was also the representative of a broker-dealer informed Gintel, another representative of the same broker-dealer, that Curtiss-Wright Corp. would be cutting its regular dividend. Gintel immediately entered sell orders for his wife's and his customers' Curtiss-Wright stock. Shortly thereafter, the information was released publicly and the price dropped quickly and substantially.

The Commission began its analysis by noting of the affirmative duty of disclosure that this "special obligation has been traditionally required of . . . officers, directors, and controlling stockholders."³¹ Furthermore this special obligation rested on two principal elements:

[F]irst, 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 when a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.³²

Under this test the Commission found that Gintel had breached this special obligation,³³ and the Commission introduced three concepts that would permeate later 10b-5 actions. First, the Commission significantly expanded rule 10b-5 by announcing that the duty is not confined to classic insiders;³⁴ rather, the duty is imposed on any person who has a "relationship" through which he acquires information regarding a corporation's internal affairs.³⁵ Second, the duty is owed to existing and future stockholders.³⁶ Third, the Commission's reliance on the inherent unfairness of trading on the basis of non-public information added a novel and surprisingly subjective approach for assigning liability.³⁷

In *SEC v. Texas Gulf Sulphur Co.*, the court embraced the SEC's inherent unfairness approach and went one step further by advocating that "all

were majority stockholders and thus acquired a duty to disclose material facts affecting the value of the stock known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders. 99 F. Supp. at 828-29. The court noted that the duty of disclosure arises from the "necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority stockholders. . . . Some courts have called this a fiduciary duty while others state it is a duty imposed by 'special circumstances.'" *Id.* at 829.

30. *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

31. *Id.* at 912.

32. *Id.*

33. *Id.*

34. A "classic" insider is an officer or director of the corporation.

35. 40 S.E.C. at 912.

36. *Id.* at 913-14. This duty had a basis in common law, not just under 10b-5. *Gratz v. Cloughton*, 187 F.2d 46, 49 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951).

37. The court could have extended the common law doctrine to impose the disclosure duty on a person who receives information from a classic insider without introducing the relative fairness of trading on the basis of unshared or unequal information, by linking the duty back to the insider.

investors on impersonal exchanges have relatively equal access to material information."³⁸ The court shifted the focus of the disclose or refrain duty from a fiduciary relationship to possession of information by declaring that "anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."³⁹ In *In re Investors Management Co.*, the Commission also accepted the equal access theory.⁴⁰ In *Shapiro v. Merrill Lynch, Pierce, Fenner, & Smith, Inc.*, the court pushed the equal access theory to its logical extreme by imposing upon the insiders a duty to the marketplace rather than solely to those who purchased stock from them.⁴¹

38. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied sub nom.*, *Coates v. SEC*, 394 U.S. 976 (1969). Texas Gulf Corp. discovered substantial mineral deposits in eastern Canada and sought to keep the information confidential in order to allow the company to acquire mineral rights for the adjoining areas. When rumors began to circulate, Texas Gulf issued a press release indicating that reports of the find were greatly exaggerated. From the period of the original drilling until the second press release, which announced a great strike, insiders and their tippees purchased Texas Gulf stock and calls without disclosing information regarding the find. In holding that the corporation's various insiders and tippees had violated Rule 10b-5, the Second Circuit expanded the parameters of the insider trading doctrine far beyond earlier court decisions and in some respects beyond *Cady, Roberts*.

39. 401 F.2d at 848.

40. 44 S.E.C. 633 (1971). Employees of Merrill Lynch, a prospective underwriter for Douglas Aircraft, tipped clients of Douglas Aircraft that a forthcoming quarterly report would show substantially reduced earnings and earning estimates. The commission held that "one who obtains possession of material, non-public corporation information, which he has reason to know emanates from a corporate source and which by itself places him in a position superior to other investors, thereby acquires a relationship with respect to that information within the purview and restraints of the antifraud provisions." *Id.* at 644.

41. 495 F.2d 228, 236-37 (2d Cir. 1974). Shapiro was an investor who bought shares of Douglas stock between the discovery of minerals and the second press release announcing the strike. The court wrote: "We hold that defendants owed a duty—for the breach of which they may be held liable in this private action for damages—not only to the purchasers of the actual shares sold by defendants (in the likely event they can be identified) but to all persons who during the same period purchased Douglas stock in the open market without knowledge of the material inside information which was in possession of defendants." *Id.* at 237.

Shapiro was important in several other respects. First, the court held that 10b-5 was applicable in a private damage action, not just an injunction action as in *Texas Gulf Sulphur*. Second, it held that tippees could incur liability even though they did not trade themselves. Finally, the court held that neither reliance nor privity was a requisite to 10b-5 liability. Instead, the plaintiffs must only prove that the information was material and withheld by the defendants.

Several other courts have disagreed with the harsh result of *Shapiro* that allows damages to all purchasers of stock during the period between defendants' transactions and the public disclosure of the information; these damages could easily and substantially exceed the losses avoided or gains acquired through the use of insider information. *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977); *see Imperial Supply Co. v. Northern Ohio Bank*, 430 F. Supp. 339, 354-55 (N.D. Ohio 1976).

Even the Second Circuit has evinced an intent to limit the potential scope of *Shapiro* by emphasizing that only plaintiffs who trade contemporaneously with the insider or tippee may prove causation in fact and thus recover damages. *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 94-95 (2d Cir. 1981); *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 172-73 (2d Cir. 1980).

Other courts have confirmed the *Shapiro* analysis that proof of relationship to the source was not necessary. *See, e.g., SEC v. Monarch Fund*, 608 F.2d 938, 943 (2d Cir. 1979); *SEC v. Geon Indus.*, 531 F.2d 39 (2d Cir. 1976); *Tarasi v. Pittsburgh Nat'l Bank*, 555 F.2d 1152 (3d Cir.), *cert. denied*, 434 U.S. 965 (1977).

Though *Shapiro* is a private action as opposed to a criminal action, it represents the decaying of the fiduciary duty concept before *Chiarella v. United States*.⁴²

C. *Chiarella: Revival of the Fiduciary Relationship Requirement*

The expansion of insider trading liability based on equal access to information was ostensibly extinguished by the Supreme Court in *Chiarella v. United States*.⁴³ Vincent Chiarella, an employee of a financial printer, identified takeover targets from the documents being printed and used this information to trade in the securities of the targets.⁴⁴

In a complicated decision, the Court began with an analysis of the common law and stated that "the duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.'"⁴⁵ The Court concluded that Chiarella owed no duty to the sellers of the target company's stock because he "had no prior dealings with them. He was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was rather, a complete stranger . . ."⁴⁶ Thus in both result and language the Court apparently brought an abrupt end to the "equal access" doctrine and revived the fiduciary concept.

II. DIRKS AND THE MISAPPROPRIATION THEORY, TEMPORARY INSIDER THEORY, AND PERSONAL GAIN REQUIREMENT

In basing the duty to disclose or abstain on a fiduciary relationship, the Court in *Chiarella v. United States*⁴⁷ relied on common law principles and

42. *Chiarella v. United States*, 445 U.S. 222 (1980).

43. *Id.*

44. Chiarella did not simply read the names from the documents. The documents were anonymous in an effort to keep the identity of the firms secret. *Id.* at 245.

45. *Id.* at 229 (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)). Powell delivered the opinion of the Court, in which Stewart, White, Rehnquist, and Stevens joined. Stevens filed a concurring opinion. Brennan filed an opinion concurring in the judgment. Burger filed a dissenting opinion. Blackmun filed a dissenting opinion in which Marshall joined.

Justices Brennan and Burger both argued that Chiarella's conviction should be affirmed because he breached a fiduciary duty by misappropriating confidential information from his employer. Burger stated that he read § 10(b) and rule 10b-5 "to mean that a person who has misappropriated non-public information has an absolute duty to disclose that information or to refrain from trading." *Id.* at 241.

The majority did not decide whether the misappropriate theory was valid because it was not submitted to the jury. The Court specifically noted that the jury instructions were deficient because they contained no "elements of a duty owed by petitioner to anyone other than the sellers." *Id.* at 237. Justice Brennan concurred in the judgment and disagreed with Justice Burger because he felt that a fiduciary relationship was never identified and submitted to the jury.

46. *Id.* at 233-34.

47. 445 U.S. 222, 227-28 (1980).

the two elements articulated in *In re Cady, Roberts & Co.*⁴⁸ The common law notion of fiduciary duties as they applied to corporations and the securities markets, however, was not uniform⁴⁹ and the rationale in *Cady, Roberts* places very little significance on duties.⁵⁰ Consequently, the Court did not delineate precisely what duties and relationships were within the parameters of the fiduciary concept.⁵¹

In *Dirks v. SEC*, the Supreme Court emphatically affirmed the analysis in *Chiarella*: a duty arises only from a fiduciary relationship, not from mere possession of information.⁵² The "temporary insider" concept, "improper purpose" requirement and misappropriation theory, however, add another dimension to the Court's analysis. Although the rationale from *SEC v. Texas Gulf Sulphur Co.*,⁵³ *In re Investors Management Co.*,⁵⁴ and *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*⁵⁵ is supposedly rejected, the results are not. In *Texas Gulf*, the tippees could be liable because they received information for an improper purpose;⁵⁶ and in *Investors Management* and *Shapiro* the underwriters could be classified as "temporary insiders," thereby violating their duty by releasing information.⁵⁷ In each instance, the insiders who divulged the information, whether they were temporary or regular, received a personal gain from the release of the information according to the guidelines established by *Dirks*.⁵⁸

A. *The Expansiveness of the Misappropriation and Temporary Insider Concepts*

The potential expansiveness of the fiduciary principle in the context of *Dirks* is vivid when applied to a situation such as in *Chiarella*. First, *Chiarella* could be considered a temporary insider of the acquiring corporation. Certainly, *Chiarella* entered into a special confidential relationship in the conduct of the business of the enterprises and was given access to information for corporate purposes by virtue of his employment with the printing firm.⁵⁹ It is equally obvious that the corporation expected to keep the information

48. 40 S.E.C. 907 (1961).

49. See *supra* notes 18-29.

50. The elements of the *Cady, Roberts* rationale are cast in terms of "access" and "fairness." Thus the duty there depends on "access" and "fairness," as opposed to a fiduciary relationship that is articulated in *Chiarella*.

51. The holding in *Chiarella* is narrow: the possession of information does not give rise to a duty to disclose or abstain. 445 U.S. at 235.

52. *Dirks v. SEC*, 103 S. Ct. 3255, 3261 (1983).

53. 401 F.2d 833 (1st Cir. 1968).

54. 44 S.E.C. 633 (1971).

55. 495 F.2d 228 (2d Cir. 1974).

56. See *supra* note 38.

57. See *supra* notes 40 & 41.

58. *Dirks*, 103 S. Ct. at 3265. See also *infra* notes 80 & 81 and accompanying text for a discussion of what could be deemed improper.

59. *Chiarella*, 445 U.S. 222.

confidential, and that the relationship implied such a duty because the names of the firms were meant to be kept secret.⁶⁰ The main roadblock to a theory is that the Supreme Court made reference only to situations in which the information was acquired legitimately, as in the case of an underwriter, accountant, lawyer or consultant.⁶¹ Chiarella, on the other hand, stole information that was never intended to be given to him.⁶²

Also, as Chief Justice Burger indicated in his dissent, Chiarella could be liable for "misappropriating" the information.⁶³ Indeed, the misappropriation theory has been used successfully in at least two lower court cases since *Chiarella*. In *United States v. Newman*,⁶⁴ employees of an investment banker told others of impending acquisitions or tender offers. These "tippers" then purchased securities of the target companies based on their possession of insider information.⁶⁵ The court of appeals held that the employees, by divulging the information, could have breached a duty of silence owed to their employers, "sully[ng] the reputations of [the employers] as safe repositories of client confidences," which acted as a fraud upon them.⁶⁶ The misappropriation theory was also used successfully in *SEC v. Materia*⁶⁷—a case with facts nearly identical to *Chiarella*. *Materia* worked for a financial printer and purchased securities of five corporations based on material non-public information he received via his employment.⁶⁸ The district court relied on and upheld the *Newman* decision, ruling that the use of the information by the printer's employee operated as fraud on the bidders in the tender offer and did not require a pre-existing duty or other link between the defendant purchaser and shareholder of the target company.⁶⁹ In *Newman* and *Materia*, both tender offer cases and criminal actions, the courts held that the fraud had been committed upon the acquiring companies, and that the purchase of securities from the issuer, furthermore, satisfied the "in connection with"⁷⁰ clause, thus invoking liability under 10b-5.

60. *Id.*

61. *Dirks*, 103 S. Ct. at 3261 n.14.

62. *See Chiarella*, 445 U.S. at 224.

63. *See id.* at 242 (citing *In re Blythe & Co.*, 43 S.E.C. 1037, 1040 (1969)).

64. 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 104 S. Ct. 193 (1983).

65. *Id.*

66. *Id.* at 17.

67. [1983-1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,526 (S.D.N.Y. 1983).

68. *Id.*

69. The court held that neither *Dirks* nor *Moss v. Morgan Stanley*, *see infra* text accompanying notes 71-75, undermined *Newman*. It argued that the court in *Moss* simply denied recovery of damages by a seller of the target company's securities on the ground that there was no duty to the seller, but didn't purport to overrule *Newman*. The court further felt it necessary to distinguish *Dirks* on the ground that disclosure in that case involved exposure of a crime.

The fact that the court distinguished *Dirks* reveals that it was a bit uncomfortable with the relationship it developed between *Materia* and the acquiring firm. It also suggests the possibility of lower courts construing *Dirks* very narrowly, thus limiting its rationale to cases that involve the exposure of fraud.

70. Normally, fraud under 10b-5 is based on the relationship between purchaser and seller. Under the misappropriation theory as used in *Newman* and *Materia*, there was no relationship between the purchaser and seller. *See note 7* for the context of "in connection with."

One case that could inhibit the use of the "temporary insider" and misappropriation theory is *Moss v. Morgan Stanley, Inc.*, a private damage action that dealt with a proposed tender offer.⁷¹ Courtois, an employee of the mergers and acquisitions department of Morgan Stanley, told two others about a proposed tender offer. The three subsequently bought 11,200 shares of the target company's stock on Nov. 30, 1976. On the same day, the appellant Moss sold 5000 shares of the company's stock. Moss subsequently commenced a class action on behalf of the investors who sold the target stock on Nov. 30, 1976, alleging violations of 10b-5.⁷² The court in *Moss* held that the defendants were not traditional insiders and therefore did not fall within the class of temporary insiders described in *Dirks*. The court stated, however, that the complaint was "patently deficient" because it described a fiduciary relationship only between the acquirer and Morgan Stanley and was "barren of any factual allegations" that might create a duty between the issuer and Morgan Stanley.⁷³ Thus, if Moss could have described a fiduciary relationship between the issuer and Morgan Stanley, one in which the investment banking firm was expected to keep any information concerning the tender offer confidential, liability would have been plausible.

The court also rejected the misappropriation theory of *Moss* by saying: "[n]othing in our opinion in *Newman* suggests that an employee's duty to 'abstain or disclose' with respect to his employer should be stretched to encompass an employee's 'duty of disclosure' to the general public."⁷⁴ The court is concerned with the same issue as in *Chiarella*: whether the abstain or disclose duty depends on the relationship between parties or the mere possession of information.⁷⁵ *Moss* tried to establish a fiduciary duty in a conclusory way: the defendants received nonpublic information and hence acquired a fiduciary duty.⁷⁶ But this concept of duty is precisely what *Chiarella* and *Dirks* emphatically rejected. Therefore, Moss' failure was not a failure of the misappropriation theory but a failure of Moss to establish a fiduciary duty based on a relationship between the issuing corporation and Morgan Stanley.⁷⁷ The court in *Moss* left open the possibility of finding a relationship between the issuer and the defendant, thus preserving some of the vitality of the misappropriation theory in private damage actions factually similar to *Moss*.⁷⁸

71. [1983-1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,478 (2d Cir. 1983).

72. *Id.* at 96,751.

73. *Id.* at 96,756.

74. *Id.* at 96,755.

75. See *supra* notes 44-46 and accompanying text.

76. This argument is perfectly tautological: one must disclose or abstain from trading on material information when he has a duty to do so. He assumes that duty when he receives material nonpublic information.

77. *Moss* at 96,758.

78. See *id.* at 96,756.

The viability of the temporary insider and misappropriation theories is supported by their successful employment in *Newman* and *Materia*.⁷⁹ Hence, while the Court has abolished the equal access to information doctrine and made it more difficult to find outsiders guilty as tippees through the imposition of an improper purpose requirement, it has expanded the fiduciary principle to allow some outsiders to be treated as insiders and thus ease the evidentiary burden for the SEC. The ultimate unambiguous impact from the combination of these theories is difficult to measure, however, because the Court has explained each theory in vague and flexible terms.

B. *The Flexibility of Each Theory*

The latitude the Supreme Court has awarded to the lower courts is particularly evident in the improper purpose requirement. The Court gave little substance to what an improper purpose was or on which purpose to focus. Secrist, the tipper in *Dirks*, conceivably had three purposes. One was to expose a massive fraud; this is laudable. Another could have been to vindicate himself for his earlier firing from Equity Funding.⁸⁰ Finally, the means Secrist chose to effectuate the other two purposes can be considered a purpose in itself; Secrist intended *Dirks* to corroborate and spread his allegations causing the stock price of Equity Funding to fall so drastically that trading would have to be halted and an investigation commanded. While one of the purposes is good, two of them could be considered bad and certainly the Court does not mean that an insider must only entertain one proper motive. The Court, furthermore, did not address why the good feeling of exposing fraud is not personal gain in the context of a proper motive requirement while the good feeling of giving information as a gift to a friend is personal gain.⁸¹

The temporary insider and misappropriation theories embody an equal amount of vagueness and flexibility. Although the courts have given some guidelines and examples,⁸² it is not obvious what "certain circumstances" and "special confidential relationships" give rise to fiduciary duty. In *Moss*, for example, it is plausible that the plaintiff, Moss, could have established a duty between the defendant and the issuing corporation.⁸³ And in *SEC v.*

79. For a case in which the temporary insider theory has been used successfully, see *infra* note 84.

80. Secrist was employed by Bankers National Life Insurance Co., an Equity Funding subsidiary. He told *Dirks* that he left it in protest over the way it was operated, but subsequently it was revealed that he was fired. See the opinion of the Securities and Exchange Commission, 21 SEC Docket 1401, 1402 n.5, 1402-1406 (1981).

81. Justice Blackmun is concerned with the means Secrist took to expose the fraud and the elusiveness of what is proper or improper. *Dirks*, 103 S. Ct. at 3273 (Blackmun, J., dissenting). See also Wang, *Recent Developments in the Federal Law Regulating Stock Market Insider Trading*, 6 CORP. L. REV. 291, 328 (1983).

82. For guidelines and examples of a "temporary insider," see *supra* notes 71-79 and accompanying text.

83. See *supra* text accompanying notes 71-78.

Lund, the district court found that a close friend of an insider who discussed and entertained the possibility of a joint venture was a "temporary insider" for purposes of the information he received during those discussions.⁸⁴

It is possible that the Court has avoided a precise statement of the theories of liability and instead based them on something as broad as fiduciary duties in order to enhance the remedial purposes of rule 10b-5.⁸⁵ Justice Blackmun obviously felt the Court's motives were more clandestine when he wrote that the improper purpose requirement was simply based on a cost-benefit analysis of Secrist's and Dirks' actions. In other words, the benefits of their action outweighed the costs in this particular instance.⁸⁶ Justice Blackmun apparently feels that the same ends could have been attained with less costly means.⁸⁷ The Court's focus, however, was not the societal gain that resulted

84. 570 F. Supp. 1397 (C.D. Cal. 1983). The *Lund* court held that a friend and business associate of an insider who traded on the basis of material, nonpublic information disclosed to him by the insider, was a "temporary insider" and therefore subject to a fiduciary duty not to trade on the basis of the information.

The court pointed out that the defendant was told by an insider about negotiations with a publicly-held company for a joint venture involving a Las Vegas gambling casino in order to determine whether a company, of which he was chief executive officer, would make a capital investment in the venture. The defendant did not have his company join in the venture, but instead traded for his personal account.

The SEC on appeal abandoned its prior argument that *Lund* should be held liable on a theory of tippee liability, but argued that the concept of an "insider" for purposes of rule 10b-5 was flexible and included not only officers and directors and controlling shareholders, but all those who had a "special relationship affording access to inside information." The court accepted this argument and held that "the test to determine insider status is whether the person has access to confidential information intended to be available only for a corporate purpose and not for the personal benefit of anyone." *Id.* at 1402 (quoting *Feldman v. Simkins Indus., Inc.*, 679 F.2d 1299, 1304 (9th Cir. 1982)). Such persons,

although not traditional "insiders," nevertheless become fiduciaries of the corporation and the shareholders [as] "temporary insiders." They assume the duties of an insider temporarily, by virtue of a special relationship with the corporation. A temporary insider is subject to liability under § #10(b) for trading on the basis of nonpublic material information received in the context of the special relationship.

Id. at 1403 (citations omitted).

85. See *L. Loss*, *supra* note 23, at 1436 (quoting from *State v. Whitaker*, 118 Or. 656, 661, 247 P. 1077, 1079 (1926)):

Were any hard and fast rule to be laid down as to what constitutes fraud . . . "a certain class of gentleman of the 'J. Rufus Wallingford' type—they toil not neither do they spin—would lie awake nights endeavoring to conceive some devious and shadowy way of evading the law. It is more advisable to deal with each case as it arises."

86. *Dirks*, 103 S. Ct. at 3272-73 (Blackmun, J., dissenting):

The Court justifies Secrist's and Dirks' action because the general benefit derived from the violation of Secrist's duty to shareholders . . . in other words, because the end justified the means. Under this view, the benefit conferred on society by Secrist's and Dirks' activities may be paid for with the losses caused to shareholders trading with Dirks' clients.

87. See *id.* at 3273. Justice Blackmun concedes himself, however, that sometimes it is difficult to disclose information: "[t]he Commission tells persons with inside information that they cannot trade on that information unless they disclose; it refuses, however, to tell them how to disclose." *Id.*

from Dirks' actions, but rather the future actions of individuals in situations similar to the one that confronted Dirks. This is evident by its emphasis on the nature of the market analyst's job and the importance of not deterring their search for information. Had the Court merely been concerned with a static cost-benefit analysis, it could have disposed of the issue with the same result by ruling that the information Dirks disseminated had no legitimate corporate purpose and hence was not inside information.⁸⁸ The Court similarly was more concerned with the effects of its rule in *Chiarella* than with the particular costs and benefits of Chiarella's activities.⁸⁹ Though Chiarella's actions were probably harmful,⁹⁰ the primary concern was the harmful effects of an equal access or parity of information rule.⁹¹

Instead of merely setting a precedent that would be applicable only to the extraordinary facts of *Dirks*, the Supreme Court wrote an opinion that will pervade subsequent actions under rule 10b-5.⁹² Since it is difficult to talk of the meanings of something so broad as fiduciary duties in the context of one case, it is helpful to reconcile the results of other cases. One way to do this is to examine *Dirks* in the context of other cases and legal and economic theories.

III. ECONOMIC AND POLICY CONSIDERATIONS OF THE USE OF INSIDE INFORMATION

A. *Equal Access to Information*

The Supreme Court is concerned with two competing policies: promoting fair and honest markets, and encouraging the search for and production of

88. Indeed, this was the argument that the attorney general made, the respondent Dirks emphasized, and other commentators suggested. See Brief of the Securities and Exchange Commission in Opposition at 17, Brief for Petitioner Raymond L. Dirks at 18, *Dirks v. SEC*, 103 S. Ct. 3255 (1983); Heller, *Chiarella, SEC Rule 14e-3 and Dirks: Fairness versus Economic Theory*, 37 BUS. LAW. 517, 548 (1982); Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 348.

89. We cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transaction to forgo actions based on material, nonpublic information. Formulation of such 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.

Chiarella, 445 U.S. at 233.

90. See Easterbrook, *supra* note 88, at 323; see generally Heller, *supra* note 88.

91. An equal access or parity of information rule would seriously discourage the search and production of valuable information. See generally Hirshliefer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561 (1971); R. POSNER, *ECONOMIC ANALYSIS OF THE LAW* § 14.9 (2d ed. 1977).

92. Some courts may try to limit the scope of *Dirks* by interpreting the Court's analysis as applicable only to disclosure of corporate crime. See *Materia*, [1983-1984 Transfer Binder] FED. SEC. L. REP. ¶ 99,526. However, others have not limited *Dirks* in such a way. See *Lund*, 570 F. Supp. 1397; *Newman*, 664 F.2d 12.

information.⁹³ The policy of fair and honest markets begs for full disclosure and equal access to information, while the search for and production of information favors the inducement of being able to exploit an informational advantage.⁹⁴ The Court claims that the equal access theory has been abolished. Merely saying that it does not exist, however, does not eliminate it, and it is not obvious from the results of the cases that such a policy does not still exist in some form.

The Court declares that the obligation to disclose or refrain is based upon a fiduciary relationship (one arising out of a feeling of trust and confidence placed in the fiduciary), and not upon "one's ability to acquire information because of his position in the market."⁹⁵ The concept of one's position in the market, however, often coincides with the concept of a fiduciary. An insider obviously has access to information a normal investor does not, and is always considered a fiduciary.⁹⁶ An outsider who is given access to information solely for corporate purposes may become a temporary insider and, consequently, a fiduciary.⁹⁷ Finally, when one misappropriates information, he is a fiduciary and concomitantly has access to information intended to be kept confidential.⁹⁸ The relationship between the fiduciary duty and access to information is further substantiated by the often quoted rationale from *In re Cady, Roberts, & Co.* that the disclose or refrain duty arises out of "a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose."⁹⁹

Depending on how equal access is defined, the fiduciary and equal access to information concepts could be regarded as mutually inclusive. Under the normal meaning of access, however, this does not appear to be true.¹⁰⁰ Everyone has different opportunities to acquire information because of his own personal resources, reputation and contacts. Requiring all market inves-

93. See generally Langevoort, *supra* note 20; Easterbrook, *supra* note 88; Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV., 322 (1979).

94. See sources cited *supra* note 93.

95. *Dirks v. SEC*, 103 S. Ct. 3255, 3263 (1983); *Chiarella v. United States*, 445 U.S. 222, 232 (1980).

96. See Brudney, *supra* note 93, at 343.

97. An issue arises here as to whether the temporary insider's fiduciary relationship is limited to that information which he obtains through his temporary insider status. For example, would an accountant hired by company X fall under the disclose or refrain rule with respect to any public material information he received concerning X, or would he fall under the duty only for the information he acquires through his relationship with X that makes him a temporary insider? Brudney might argue that the temporary insider could not use information that came to him by means other than his relationship with the corporation for the same reason that an insider cannot: "The duty not to deal with their beneficiary in trust assets on the basis of informational advantages about the trust does not rest on how they obtained the informational advantage." Brudney, *supra* note 93, at 346.

98. It is important to note here that the fiduciary relationship is owed to the acquiring company only. See *supra* text accompanying notes 69-78.

99. 40 S.E.C. 907, 912 (1961).

100. "The act or opportunity of approaching; coming to or near; admittance." FUNK & WAGNALLS STANDARD DESK DICTIONARY (1974).

tors to have the same access to information seems to imply that all would have to expend the same costs to acquire the information; since some would be able to incur less expense because of their personal resources, reputation, and contacts, this would be an unworkable policy.¹⁰¹ Also, this equal access concept is rejected not only by the language but by the result in *Dirks*, since *Dirks*' costs of obtaining the information were less than those incurred by the average investor because of his resourcefulness, reputation and "position in the market."¹⁰²

Professor Brudney had advocated a much more limited interpretation of the equal access theory.

If one transactor, by reasons of his profession or regular occupational interests or otherwise, acquires material non-public information *which he is not lawfully permitted to disclose* to other transactors or which *public transactors cannot lawfully acquire*, use of that information by the former to his advantage and the latter's disadvantage is likely to be counter-productive in economic effect.¹⁰³

If people were allowed to trade on their informational advantage that others could not acquire lawfully, it would raise the cost of capital.¹⁰⁴ Furthermore, the incentives produced by letting persons trade on information that others cannot acquire legally do not justify the costs:

Whether it is inside corporate information or market information or any other imaginable relevant information, it is sought—and made available to select few—in the course of fulfilling other purposes, such as rendering services or selling goods to the source of the information or others; and therefore, the incentive for personal gains from trading is not necessary to induce those few to pursue it.¹⁰⁵

An insider or temporary insider could not trade on the information acquired in a fiduciary capacity because such inducement is not necessary. The trading, therefore, has no socially redeeming value and raises the cost of capital causing unambiguous damage to the market.¹⁰⁶

Brudney's unerodable informational advantage theory does not fully explain, however, why the Court accorded the role of market analyst such

101. Professor Easterbrook thinks for this reason that "access" is a meaningless term: "People do not have or lack 'access' in some absolute sense. There are, instead, different costs of obtaining information." Easterbrook, *supra* note 88, at 330. See also Galeno, *Drawing the Line on Insiders and Outsiders for Rule 10b-5*, 4 HARV. J.L. & PUB. POL'Y 203, 227-33 (1981).

102. 103 S. Ct. at 3263 (quoting *Chiarella*, 445 U.S. at 232-33 n. 14.)

103. Brudney, *supra* note 93, at 355.

104. *Id.* at 356. See also *infra* notes 112-15 and accompanying text.

105. Brudney, *supra* note 93, at 356.

106. While this assertion seems fairly certain in the case of an insider, it is less compelling in the case of the temporary insider. Some information the temporary insider acquires may not be through the course of his employment, see *supra* note 97, hence the trading may be a valuable incentive. The costs of drawing such a line between information acquired through the fiduciary relationship and other information may outweigh the incentives such a policy would create.

deference in *Dirks*. The majority hypothesized that an analyst could receive inside information without incurring a duty to disclose: "For example, it may not be clear—either to the corporate insider or the recipient analyst—whether the information will be viewed as material nonpublic information. Corporate officials may mistakenly think that the information has already been disclosed or that it is not material enough to affect the market."¹⁰⁷ The Supreme Court is concerned with the willingness of corporate officers to release information so that a market professional can conduct more fruitful investigations and add to his "mosaic" of information.¹⁰⁸ If the corporate officers are continuously haunted by the prospect of 10b-5 liability they will be less accommodating to the market professional's search for information.¹⁰⁹ Arguably, this deference could create an unerodable information advantage between a market professional and the normal investor. The Supreme Court indicates that it would be much more sympathetic to an accidental disclosure between a market professional and an insider, than to one between an investor and an insider; therefore, the exchange of information will be less inhibited between the insider and the market professional. While this deference may not comport with the letter of Burdney's theory, it is merely a presumption based on the roles of different actors in the market that can be overcome.¹¹⁰ In other respects the Supreme Court appears to have labeled certain types of access to information as fiduciary relationships. As Brudney would suggest, each of the actors that falls into the fiduciary status has an unerodable information advantage.¹¹¹

107. *Dirks*, 103 S. Ct. at 3265.

108. "Mosaic" refers to the composite of information the analyst gathers. Some information may not become material until it is evaluated in the context of the mosaic. It is plausible that the Court is concerned with information that is not material to the insider but is to the analyst; if the insider could be liable for giving information that he thought was immaterial but the analyst could show was material, it would have an adverse effect on the insider's cooperation.

109. It could be argued that this is not just for the general benefit of the market place but for the benefit of the firm. Financial analysts are often responsible for discovering latent production capabilities and more efficient financial strategies.

110. In *Dirks* the Court said:

In determining whether the insider's purpose in making a particular disclosure is fraudulent, the SEC and the courts are not required to read the parties' minds. Scier in some cases is relevant in determining whether the tipper has violated his *Cady, Roberts* duty. But to determine whether the disclosure itself "deceive[s], manipulate[s], or defraud[s]" shareholders . . . the initial inquiry is whether there has been a breach of duty by the insider. This requires courts to focus on objective criteria, *i.e.*, whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings.

103 S. Ct. at 3265-66 (citations omitted). The role that the recipient of information is playing in the market at the time of the receipt would seem to be merely one of the objective criteria.

111. The converse is not necessarily true; the person who has an informational advantage may not be a fiduciary. Although the misappropriation theory and temporary insider doctrine can cover most cases, the insider of a firm about to award a contract to firm *B* may be able to trade in firm *B*'s stock, and a supplier of firm *B* may be able to trade in *B*'s stock upon receipt of a large order from firm *B*.

B. Fairness

The policy of furthering fair and honest markets is often described in vague and humanistic terms.¹¹² These foundations can also be derived from economic theory. The securities markets can be viewed as a zero sum gambling game.¹¹³ If the insiders are believed to be winning abnormally often because of their access to material inside information, the average investor will either: require a risk premium,¹¹⁴ or try to obtain the information corruptly in order to erode the information advantage.¹¹⁵ In addition, allowing the insiders to trade may induce the managers to select riskier projects in order to increase the volatility of the firm's stock prices.¹¹⁶ Each has the effect of raising the cost of capital.¹¹⁷

Allowing insiders to trade on their informational advantage would raise their returns and thus increase the risk premium demanded by shareholders and ultimately the cost of capital. Similarly, when an insider of a corporation "tips" an outsider and receives a tangible or intangible benefit in return for the information, he does so at the expense of the other shareholders of the corporation as much as if he had traded on the information himself. The Supreme Court was concerned with precisely this when it noted that "[t]he theory . . . is that the insider, by giving the information out selectively, is in effect selling the information to its recipient for cash, reciprocal infor-

112. Many phrase the purpose of the 1934 Act in terms of promoting fairness and preventing manipulation without explaining what is fair and what is manipulative. See generally Ferber, *The Case Against Insider Trading: A Response to Professor Manne*, 23 VAND. L. REV. 621 (1970); Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425 (1967).

113. See Scott, *Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy*, 9 J. LEGAL STUD. 801, 807-10 (1980).

114. *Id.*

115. See Brudney, *supra* note 93, at 356. Brudney expresses another possibility that the investor may avoid dealing with the insider altogether. Though this is a tenable argument it seems safe to say that it is unnecessary because the investor could always be lured by a high risk premium.

116. The manager's expected gain may be higher by selecting riskier projects if he could trade on inside information. If the project fails he would only lose his salary at most but if the project succeeds he could make many times his salary. In most cases the loss would simply be shouldered by the shareholders. See Easterbrook, *supra* note 88, at 332.

117. The cost of capital can be evaluated in several different ways. First, the cost of capital for the entire market would increase if insiders were allowed to trade because the return perceived by the average investor would not be as high as if the insiders were barred from trading. Most commentators seem to talk in terms of an entire market when they make this argument. See Brudney, *supra* note 93, at 356 ("If the market is thought to be systematically populated with such transactors . . ." referring to people trading on inside information and raising the cost of capital).

Second, the cost of capital for a single firm might increase if it were known that the insiders were trading on their information. In this case the cost of capital theory would transcend economic analysis and market efficiency; the insider would be responsible for diminishing the value of the property he holds in trust. The reasoning, however, begs the next question: does the value of the trust really diminish? Perhaps not if the corporation does not plan to enter the primary security market, and the diminished market value of the secondary securities does not adversely affect the firm.

mation, or other things of value for himself."¹¹⁸ In other words, the Court seems to be worried about a transfer of wealth in which the insider gains at the expense of the shareholders of the same corporation.¹¹⁹

The transfer of wealth theory sheds a different light on *Dirks*. Because Secrist did not allegedly gain,¹²⁰ he did not cause the shareholders as a class to lose. As a group the shareholders would have ultimately lost the same amount no matter what Secrist did. Secrist only made the loss materialize more quickly. Hence, there was no redistribution of wealth between the class of shareholders and the insiders.¹²¹

Justice Blackmun, in his dissent argues that the result in *Dirks* is unfair: "The fact that the insider himself does not benefit from the breach does not eradicate the shareholders' injury."¹²² Perhaps Justice Blackmun believes that the shareholders should receive identical returns, and the fact that those who sold their stock avoided a loss is thereby unfair.¹²³ But, as another commentator has noted, this result is incorrect because it does not explain why some decided to buy and why some decided to sell.¹²⁴ Nor does it recognize the fact that some shareholders lose and some gain whenever stocks are traded.¹²⁵

The transfer of wealth concept can also help explain why the person who misappropriates information from an acquirer in a proposed tender offer is not liable to the issuer in a private damage action under 10b-5.¹²⁶ The insider of the issuing corporation has not benefited and the insider of the acquiring corporation, who has been damaged, owes no duty to the shareholders of the issuing corporation. There has, consequently, been no transfer of wealth between the insiders and the outsider except to the point that the outsider

118. *Dirks*, 103 S. Ct. at 3266 (quoting Brudney, *supra* note 93, at 348).

119. It is important to note that the transfer must occur between insiders and shareholders of the same corporation. In a tender offer situation the insiders of a corporation could lawfully trade in the shares of the issuing corporation under 10b-5. The Second Circuit court in *Chiarella* had trouble explaining why the printer could not trade in the shares but the insiders could. This may have resulted from the court not explicitly stating what types of redistribution it thought was unfair. For a related point see Scott, *supra* note 113, at 814.

120. Whether Secrist gained depends on the definition of gain. See *infra* text accompanying notes 121-53.

121. In *Dirks* the redistribution occurred only between shareholders. However, one might argue that the shareholders who avoided a loss were friends of Secrist.

122. *Dirks*, 103 S. Ct. at 3271 (citations omitted). Justice Blackmun relies on the law of trusts to state that the trustee is liable for acts causing diminution of value to the trust. See A. SCOTT, *THE LAW OF TRUSTS* § 205, at 1665 (1967). This is a strange application to the fact situation of *Dirks*. Corporate officials are not subject to the same duties as a trustee. See *id.* § 16A. Even if they were subject to the same duties Secrist did not create a diminution in the value of the trust. Also the relationship of trusteeship is awkwardly applied in a situation involving corporate fraud.

123. See Easterbrook, *supra* note 88, at 324.

124. *Id.* This is especially true in *Dirks*. Some shareholders after hearing *Dirks*' allegations and noticing the fall in the price of Equity Funding stock, bought more shares believing that the price was artificially depressed.

125. *Id.* at 325.

126. See *supra* text accompanying notes 64-78.

has benefited at the expense of the insiders of the acquiring corporation.¹²⁷

C. Market Efficiency

1. Flow of Information

The efficient capital market hypothesis states that the more quickly accurate information is disseminated into the market, the more quickly financial and ultimately real resources will be allocated to their most efficient uses.¹²⁸ The Supreme Court has apparently subscribed to such a view in *Dirks* by recognizing the need to search for and produce information and accord deference to market professionals.¹²⁹

a. positive or negative

The disclose or refrain rule may be too strong. It has been argued that the rule should apply not to all types of information, but only to positive information.¹³⁰ If the information is positive and the insider is under the disclose or refrain duty, he will be inclined to disclose the information since by withholding it he cannot accrue any extra profits through trading.¹³¹ The same is not true if the information is negative. In that case, the insider may refrain from disclosing the information in order to protect his reputation or avoid liability.¹³² Resources, consequently, will not be allocated efficiently.¹³³

The positive/negative distinction could have been applied in *Dirks*. If Secrist and *Dirks* had fallen under and adhered to the disclose or refrain duty, *Dirks* would not have had sufficient incentive to vigorously pursue Secrist's allegations. Since *Dirks* could exploit the informational advantage to enhance his reputation, he continued his investigations and truncated a costly fraud.¹³⁴ Because Secrist ostensibly did not benefit,¹³⁵ his actions unambiguously enhanced market efficiency. Had he benefited, however, the

127. The outsider has gained and the acquiring corporation has been damaged by the rise in the issuer stock's price.

128. *E.g.*, Heller, *supra* note 88, at 530.

129. *See Dirks*, 103 S. Ct. at 3263 ("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").

130. *See* Scott, *supra* note 113, at 811.

131. *Id.* at 810.

132. *Id.* One can argue that the insider's interest in future credibility will induce him to release the information. On the other hand, businesses have been known to try to cover up their earlier mistakes.

133. *See generally* Heller, *supra* note 88.

134. *Dirks* wanted a reputation of taking care of his clients well, not just the general fame that disclosure to the SEC followed by a successful investigation could have rewarded him. *See Dirks*, 103 S. Ct. at 3269 n.4 (Blackmun, J., dissenting).

135. *See* text accompanying notes 80-81.

net gain from his disclosure to Dirks would have been at issue. While the flow of information would have been improved, there would have been a transfer of wealth involved between an insider and an outsider, thus potentially raising the cost of capital. This was the case in *In re Investors Management Co.*, in which the tippees received non-public information regarding a decrease in quarterly earnings from Merrill Lynch. Merrill Lynch, because of its status as underwriter for the firm, could have been deemed to possess a temporary inside relationship.¹³⁶

b. foreknowledge v. discovery

The Supreme Court felt that recognizing a duty to disclose or refrain for the mere possession of inside information could have an inhibiting influence on the role of market analysts and the production of information.¹³⁷ Moreover, allowing a financial analyst to parlay the information he discovers into reputational benefits by advising his clients is a vital incentive to a vigorous search for information.¹³⁸ Allowing an outsider to benefit from foreknowledge, however, is not beneficial and implies that the ultimate source sold it selectively for something of reciprocal value.¹³⁹ Often it is the insider who has sold this information, and as a result, a redistribution of wealth between the class of shareholders and the insiders of the corporation occurs.

Raymond Dirks clearly produced information when he corroborated allegations and disclosed a fraud that had eluded the investigations of three major accounting firms.¹⁴⁰ If he had known before his investigations that his efforts could not have been translated into a reputational benefit, it is doubtful he would have investigated.¹⁴¹ Dirks did not receive any information that another diligent and resourceful analyst could not obtain.¹⁴² In sum, Dirks' actions were clearly laudable, the motive was necessary to his search, and he produced material information. The opposite result is true, however, in almost every other case in which the courts have held a tippee liable under 10b-5.¹⁴³ The information was not obtained by skill and industry, but rather through a gift emanating from an insider.

136. *Dirks*, 103 S. Ct. at 3261 n.14.

137. This is what the court is concerned with when it writes: "It is the *nature* of this type of information, and indeed of the markets themselves that such information cannot be made simultaneously available to all of the corporation stockholders or the public generally." *Dirks*, 103 S. Ct. at 3263 (emphasis added).

138. *Id.*

139. Indeed it seems almost satirical for the SEC to argue that Dirks received material information. It apparently was not material for the SEC to command further investigations. It was Dirks' research that made the information material. *See Dirks*, 103 S. Ct. at 3259 n.8.

140. *See id.*

141. Dirks himself was willing to talk to anyone that would call him. *See id.* at 3255.

142. *Id.*

143. *See Easterbrook, supra* note 88, at 331.

2. Management Costs

To induce individuals and corporations to search and acquire socially valuable information, those same individuals and corporations must be able to exploit the information upon obtaining it. Disclosure of some information reduces its value to the rightful owner and in some cases insider trading can operate as disclosure.¹⁴⁴ When an insider trades in the issues of a firm to which his corporation will soon make a tender offer, he raises the price of such issues and decreases the value of the tender offer information to his corporation.¹⁴⁵ Hence, some uses of inside information decrease the value of the information to the business entity.

Misuse of information can impose other costs. If the insider is allowed to trade on his informational advantage, he is encouraged to manipulate the timing and release of the information to alter prices and avoid detection in an effort to profit from the information.¹⁴⁶ This could be a costly use of the investor's time and effort that would be better spent managing principal. If it is known, furthermore, that the insider is trading, the firm's cost of capital will increase in the primary market for securities, and the price of the secondary market securities will decline.¹⁴⁷

United States v. Chiarella is an example of how the misuse of information can cause the value of the information to decline. Searching for companies to acquire is socially valuable. If Chiarellas are allowed to misuse the information, however, firms will either stop searching for the information or incur extra costs to protect it.¹⁴⁸ In *SEC v. Texas Gulf Sulphur Co.*, the issuance of the second press release allowing insiders to trade on their information was costly not only from the standpoint of the dollar cost of the release and other protective measures, but also from the opportunity cost of the management's time and effort spent contriving and operating the manipulative devices. Furthermore, this activity, had it been allowed to continue, could have affected the primary and secondary market securities adversely. The information relating to Equity Funding's corporate fraud, however, was not legitimate or socially desirable information; it impeded the efficient allocation of financial and ultimately real resources. While its concealment encouraged the further production of such information, its disclosure ended the costly protection of the information.

144. *Id.* See also *supra* text accompanying notes 66-82.

145. See generally Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

146. See *supra* note 117.

147. If the firm knows that others can exploit the information they have searched to obtain, it will incur costs keeping the information secret.

148. The protection of the information of Equity Funding was costly in two respects: (1) the effort and money of Equity Funding to protect the fraud; and (2) the cost of prolonging the investigations.

IV. FRAMEWORK OF A BALANCING TEST

The arguments paraded above represent some that can be reconciled with what appears to be the current rationale and position of the Supreme Court. By creating a flexible fiduciary duty concept the Court has shown that it is amenable to both fairness and efficiency concerns. Because the duty is flexible it will not always be clear exactly who is and who is not a fiduciary and whether the duty has been breached. When there is such uncertainty, the analysis should consider whether the defendant has an uneredable informational advantage, and should evaluate the effect of any rule arising from the analysis on the cost of capital, the production of information, and management costs.

In many instances, applying these different arguments will not give an unambiguous answer. *Dirks* is an example of this situation. Dirks probably enhanced market efficiency because he helped inform the market of Equity Funding's true financial position. Dirks' actions, however, also may have raised the cost of capital. Though Secrist did not receive any monetary benefit, he probably did receive a reputational benefit. A transfer of wealth between a class of outsiders and a class of insiders was thus created, and the actions of Dirks to some degree were, therefore, unfair.

The same ambiguity is present when analyzing the effects of the rule from *Dirks*. The absolution of Dirks will enhance the market analyst's search for information in the future, but will do so at the expense of facilitating future transfers of wealth between insiders and shareholders. In other words, there is a trade off between allocating resources more efficiently and fairness.

It is exactly these concerns of efficiency and fairness that the court struggled with in *Dirks*. Justice Powell wrote that convicting Dirks would encumber the market analysts' search for information.¹⁴⁹ Justice Blackmun, on the other hand, argued that the scienter requirement is sufficient to protect the analyst.¹⁵⁰ Both Justices' views are tenable depending on the importance ascribed to the market analyst and the protection the analyst is accorded by the scienter requirement.

Both Blackmun's and Powell's analyses of the fairness of Dirks' actions, however, are flawed. The result in *Dirks*, according to Justice Powell, is fair because Secrist did not benefit at the expense of the shareholders.¹⁵¹ As discussed earlier, this result is not correct because Secrist probably received a reputational benefit.¹⁵² Justice Blackmun contended that the result, regardless of the insider's motives, is unfair because some shareholders were losers.¹⁵³ This is not quite correct either, because some shareholders will

149. 103 S. Ct. at 3262-63.

150. *Id.* at 3271 n.11.

151. *See id.* at 3268.

152. *See infra* notes 80-81 and accompanying text.

153. 103 S. Ct. at 3771. *See also supra* notes 122-25 and accompanying text.

always lose when shares are traded, and the fact that some shareholders do lose does not mean that a fraud has been committed. According to the analysis in this Note, Justice Powell is wrong for the right reason while Justice Blackmun is right for the wrong reason. Moreover, both are incorrect because they imply that an answer to this question ends the analysis. Dirks' actions were to some degree unfair but they also contributed to a more efficient market. Condoning Dirks, furthermore, will encourage other analysts to contribute to fairness and efficiency in the same manner in the future. Though Justice Blackmun disagrees with using a balancing test, use of such test is almost inevitable when the underlying policy arguments are couched in terms of fairness and efficiency. It would have been difficult for Dirks to trade in a manner that was most fair and efficient to everyone. More importantly, the effect of any rule will rarely be to encourage people to act most fairly and efficiently simultaneously, because these are two competing policies.

CONCLUSION

The *Dirks* decision reflects the Court's willingness to look at policies that further fair and efficient markets in an attempt to give substance to the fiduciary concept. While the Court has dealt somewhat successfully with these two concerns, much development is still needed, particularly in regard to what constitutes fairness. The arguments in this Note provide the tools to develop more specific characteristics of fairness and efficiency, and reconcile the results of past cases. Since these concerns often compete against each other, it is inevitable that they will often have to be weighed against each other in the analysis.

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