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Casenotes: Securities Fraud — Rule 10b-5 — Tippee Liability Requires Breach of Fiduciary Duty by Tipper, and Tippee's Knowledge of the Breach. Dirks v. SEC, 103 S. Ct. 3255 (1983)

Nancy I. Knapp
University of Baltimore School of Law

SECURITIES FRAUD—RULE 10b-5—TIPPEE LIABILITY REQUIRES BREACH OF FIDUCIARY DUTY BY TIPPER, AND TIPPEE'S KNOWLEDGE OF THE BREACH. *Dirks v. SEC*, 103 S. Ct. 3255 (1983).

An investment analyst for a broker-dealer firm received confidential information from a former officer of an insurance holding company.[1] The former officer alleged that the insurance company was engaged in fraudulent insurance practices.[2] The analyst investigated the allegations and disclosed the information he discovered to a number of clients and other investors.[3] The corporation and many of its officers and directors were subsequently indicted for fraud,[4] and the Securities and Exchange Commission (SEC) investigated the analyst's role in exposing the fraud. The SEC found that the analyst violated section 10(b)[5] and Rule 10b-5[6] of the Securities Exchange Act of 1934

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1. Dirks v. SEC, 103 S. Ct. 3255, 3258 (1983). Neither the analyst nor the broker-dealer firm owned or traded any of the insurance company's stock. The analyst was actually a "tipping tippee," but the Court analyzed his liability under Rule 10b-5 in the tipper-tippee context. *Id.* at 3258-60. For a discussion of second-level tipping, see W. PAINTER, THE FEDERAL SECURITIES CODE AND CORPORATE DISCLOSURE § 5.03, at 162 (1979).
2. One allegation centered upon the creation of false insurance policies and records to inflate the sales figures of one of the insurance company's subsidiaries. Dirks v. SEC, 681 F.2d 824, 829 (D.C. Cir. 1982), *rev'd*, 103 S. Ct. 3255 (1983).
3. A reporter who, fearing libel charges, initially refused the analyst's request to report the fraud, later received a Pulitzer Prize nomination for an exposé he published after trading in the securites was suspended. Dirks v. SEC, 681 F.2d 824, 831-32 (D.C. Cir. 1982), *rev'd*, 103 S. Ct. 3255 (1983).
4. After five institutional investors liquidated holdings worth more than $15,000,000 on the basis of the analyst's information, the price of the corporation's stock plummeted and the New York Stock Exchange suspended trading in the securities. Although both a former employee of the corporation and the reporter had informed the SEC of the allegations, a complaint against the company was not filed until trading in the securities was suspended. Dirks v. SEC, 681 F.2d 824, 832 (D.C. Cir. 1982), *rev'd*, 103 S. Ct. 3255 (1983).
5. Section 10 reads in pertinent part:

   > It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—. . . (b) [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any securities 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.

   15 U.S.C. § 78(j) (1982).
6. Rule 10b-5 provides:

   > It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   > (a) To employ any device, scheme, or artifice to defraud,
   > (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(1934 Act) by repeating material, nonpublic information to investors who subsequently traded on the basis of the information.[7] The United States Court of Appeals for the District of Columbia Circuit affirmed on the ground that persons who receive material, nonpublic information from corporate insiders are bound by the insiders' fiduciary obligation to disclose the information or to abstain from trading.[8] The Supreme Court granted certiorari and reversed, holding that a tippee[9] assumes a duty to abstain or disclose only when the insider breaches his fiduciary duty by disclosing the information, and the tippee knows or should have known of the breach.[10]

Although other provisions of the 1934 Act prohibit specific manipulative practices,[11] section 10(b) is a general antifraud provision designed to cover an "infinite variety" of fraudulent securities practices that may be perpetrated upon the investing public.[12] Section 10(b) and Rule 10b-5, which were issued under the 1934 Act, have been construed by both the courts and the SEC to prohibit insider trading.[13]

(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.

17 C.F.R. § 240.10b-5 (1983). The duty to disclose or abstain is traditionally thought to be based on subsection (c), but courts do not distinguish the subsections. Dirks v. SEC, 681 F.2d 824, 834 n.12 (D.C. Cir. 1982), *rev'd*, 103 S. Ct. 3255 (1983); *see* Chiarella v. United States, 445 U.S. 222, 225 n.5 (1980).

7. *In re* Raymond L. Dirks, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,812, at 83,950 (Jan. 22, 1981), *aff'd*, 681 F.2d 824 (D.C. Cir. 1982), *rev'd*, 103 S. Ct. 3255 (1983). The analyst was also found to have violated section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) (1982), a less inclusive fraud provision that is limited to the "offer or sale" of any security. The SEC also determined that the five institutional investors violated section 17(a) by trading on the basis of Dirks' information. *Dirks*, 103 S. Ct. at 3269 n.3 (Blackmun, J., dissenting).
8. Dirks v. SEC, 681 F.2d 824, 846 (D.C. Cir. 1982), *rev'd*, 103 S. Ct. 3255 (1983).
9. The term tippee denotes anyone who receives material, nonpublic information from a corporate insider—the tipper. 3A H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 9.20[6] (rev. ed. 1983).
10. Dirks v. SEC, 103 S. Ct. 3255, 3257-58 (1983).
11. *See* 15 U.S.C. §§ 77(q), 77(w), 77(www), 77(xxx), 78i(a)(1), 78n(e), 78k(a), 78o(c), 78r(a), 78z (1982).
12. Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 332 n.38 (1979); *see* Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (D. Del.), *reh'g denied*, 100 F. Supp. 461 (D. Del. 1951) (denying petition to reopen the case); *In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961).
13. *See, e.g.*, Chiarella v. United States, 445 U.S. 222, 226-27 (1980); Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275, 279 (2d Cir. 1975); Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 887 (2d Cir. 1972); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969), *cert. denied*, 404 U.S. 1005 (1971); *In re* Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961); Ward La France Truck Corp., 13 S.E.C. 373, 381 (1943). Corporations are also prohibited from trading on insider information under Rule 10b-5. *See* Speed v. Transamerica Corp., 99 F. Supp. 808, 830 n.12 (D. Del. 1951). *See generally* 3 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD AND COMMODITIES FRAUD § 7.4(b)(a), 4(b)(b) (1979) (insider trading prohibited under Rule 10b-5).

Insider trading is trading in the securities of a company by a corporate insider who trades on the basis of material,[14] nonpublic information[15] concerning the company's stock. Officers, directors, and controlling stockholders have traditionally been regarded as insiders.[16] The prohibition against insider trading is founded upon the premise that this trading is inherently unfair to the uninformed investor.[17]

Generally, under the common law of fraud, only affirmative misrepresentations were actionable.[18] Judicial and administrative construction of Rule 10b-5 expanded the common law of fraud and made omissions of material fact actionable by requiring corporate insiders either to disclose publicly the inside information or abstain from trading.[19] Corporate insiders are currently regarded as fiduciaries of the shareholders,[20] and this relationship is considered the source of the in-

14. Material information is information that a reasonably prudent investor would find relevant when making an investment decision. List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963).

15. Nonpublic information includes information that is not lawfully available to the investing public without the consent of the source and information that is lawfully obtainable, but has not yet been disseminated to the investing public. Brudney, *supra* note 12, at 322 n.2. Some commentators distinguish between corporate information—information from within the corporation involving assets or expected earnings—and market information. The Supreme Court in *Dirks* stated that section 10(b) and Rule 10b-5 draw no such distinction. Dirks v. SEC, 103 S. Ct. 3255, 3262 n.15 (1983); *see* Chiarella v. United States, 445 U.S. 222, 240 n.1 (1980) (Burger, C.J., dissenting).

16. H. BLOOMENTHAL, *supra* note 9, § 9.20[4], at 9.79. Section 16(a) of the 1934 Act provides a statutory definition of insider. 15 U.S.C. § 78p(a) (1982).

17. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, 70 CALIF. L. REV. 1, 2 (1982). Congress intended to eliminate the idea that use of inside information by insiders was a normal emolument of corporate office. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 n.9 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969), *cert. denied*, 404 U.S. 1005 (1971). *But see* H. MANNE, INSIDER TRADING AND THE STOCK MARKET 59-75 (1966) (inside trading permits market price to move toward its real value).

18. Brudney, *supra* note 12, at 329 n.30.

19. *See, e.g.*, Chiarella v. United States, 445 U.S. 222, 227-30 (1980); *In re* Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961). Rule 10b-5 does not expressly forbid insider trading or require disclosure of inside information. For the text of this rule, see *supra* note 6. The scheme of federal securities legislation is premised on a disclosure philosophy. Santa Fe Indus. v. Green, 430 U.S. 462, 471-73 (1977).

20. Pepper v. Litton, 308 U.S. 295, 306 (1939); Zahn v. Transamerica Corp., 162 F.2d 36, 42 (3d Cir. 1947); *see also* 3 L. LOSS, SECURITIES REGULATION 1450-51 (2d ed. 1961). Under the prior "majority rule," corporate officers and directors were not regarded as fiduciaries of the shareholders. Rather, the insider bore a duty to the corporation itself not to misuse corporate funds. This position was eroded by application of the "special facts doctrine." This doctrine imposed a disclosure duty when the existence of special facts, such as superior knowledge or bargaining position, required that the insider be considered a fiduciary. *See* Strong v. Repide, 213 U.S. 419, 431-33 (1909). Eventually, the insider's duty to the corporation was derivatively applied to the shareholders themselves. *See generally* Langevoort, *supra* note 17, at 4-7 (tracing development of insider's fiduciary duty to shareholders).

sider's duty to disclose or abstain.[21]

The prohibition against insider trading under Rule 10b-5 is now well established.[22] The investing public is similarly disadvantaged when material, nonpublic information is used by persons other than insiders. Hence, a violation of Rule 10b-5 has been found when a nontrading insider, acting as a tipper, "tipped" this information to a tippee who then traded on the basis of the information. Although it was acknowledged that tippees were sometimes subject to the duty to disclose or abstain, the decisional law was inconsistent in delineating the source of the tippee's duty and the scope of its application.[23]

The analytical basis of the duty to abstain or disclose was explicated in the seminal 1961 SEC decision, *In re Cady, Roberts & Co.*[24] In that case the director of an issuer of securities informed a partner of a broker-dealer firm that a dividend reduction in the issuer's securities was imminent.[25] The partner and his firm violated Rule 10-5[26] by selling shares of the security for discretionary accounts, with knowledge that news of the dividend reduction had not been released to the public.[27] The duty to disclose or abstain was based on two factors: a relationship that afforded access to information that was intended "only for a corporate purpose and not for the personal benefit of anyone," and the inherent unfairness involved when a person uses this information "knowing it is unavailable to those with whom he is dealing."[28]

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21. *See* L. Loss, *supra* note 20, at 1450-51. Under the tort law of misrepresentation, affirmative disclosure is required when the parties are in a fiduciary relationship. Restatement (Second) of Torts § 551 (1977).
22. *See* Langevoort, *supra* note 17, at 1 (citing cases).
23. *Compare In re* Raymond L. Dirks, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,812, at 83,945 (Jan. 22, 1981) (tipper viewed as aiding and abetting), *aff'd*, 681 F.2d 824 (D.C. Cir. 1982), *rev'd*, 103 S. Ct. 3255 (1983) *with* Chiarella v. United States, 445 U.S. 222, 230 n.12 (1980) (tippee viewed as participant after the fact). *Cf.* Schein v. Chasen, 478 F.2d 817, 822-23 (2d Cir. 1973) (under state common law, tippee is liable to the insurer as a coventurer of the insider), *vacated sub nom.*, Lehman Bros. v. Schein, 416 U.S. 386 (1974). The legislative history of the 1934 Act is silent regarding the scope of section 10(b). Sante Fe Indus. v. Green, 430 U.S. 462, 473 n.13 (1977) (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202 (1976)); *see* S. Rep. No. 792, 73d Cong., 2d Sess. 6 (1934) (sole reference to § 10 merely states that it was "aimed at those manipulative and deceptive practices which . . . fulfill no useful function"); *see also* Langevoort, *supra* note 17, at 24-25 (early cases treated tippees as insiders, based on notions of fairness).
24. 40 S.E.C. 907 (1961).
25. *Id.* at 909. The director was also an associate in the broker-dealer firm.
26. *Id.* at 911-12. The SEC also found a violation of section 17(a) of the Securities Act of 1933. 15 U.S.C. § 77q(a) (1982); *see supra* note 7.
27. Scienter is a prerequisite to Rule 10b-5 liability—whether it be intent to deceive or recklessness. Aaron v. SEC, 446 U.S. 680, 689-91 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202-04 (1976). Scienter is imputed to a tippee who knew or should have known that the information was nonpublic and came from an insider. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237-38 (2d Cir. 1974); Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 890 (2d Cir. 1972).
28. *Cady, Roberts*, 40 S.E.C. at 912. Acknowledging that the tipper, the director of

The scope of the disclosure duty established in *Cady, Roberts* was expanded by the United States Court of Appeals for the Second Circuit in *SEC v. Texas Gulf Sulphur Co.*[29] In that case, officials of a mining development company learned of a copper strike and bought stock in the company before the board of directors was informed of the mineral find.[30] The Second Circuit held that the officials violated Rule 10b-5 by trading on material, nonpublic information, but found it unnecessary to decide whether the duty to disclose or abstain was based on fiduciary principles or on the existence of "special facts."[31] Rather, the *Texas Gulf* court relied on the congressional purpose of the rule, which was to ensure fairness in securities transactions. The court emphasized policy matters, including the investing public's right to expect that all investors enjoy "relatively equal" access to material information.[32] Thus, the *Texas Gulf* decision went beyond the *Cady, Roberts* rationale by dispensing with the need for a prior relationship affording access to inside information. No relationship or regularity of access to inside information was required to create a duty to abstain or disclose. The second element set forth in *Cady, Roberts*, the inherent unfairness in the use of inside information for personal advantage, was deemed sufficient to justify the imposition of a disclosure duty on anyone possessing inside information.[33]

Following *Cady, Roberts* and *Texas Gulf*, it was uncertain whether the source of tippee liability was derivative, based on the insider's breach of his fiduciary duty by tipping, or independent of that of the insider, based on equitable principles of fairness.[34] Several cases indi-

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the issuer, probably lacked scienter because he believed that the information had already been released to the investing public, the SEC summarily concluded that the tippee bore the tipper's duty to disclose or abstain. The SEC cited the law of restitution for the proposition that one who receives confidential information from a fiduciary, knowing that the fiduciary breaches his duty by the disclosure, is liable for any profit made through use of the information. *Id.* at n.17 (citing RESTATEMENT OF THE LAW OF RESTITUTION § 201(2) (1937)). Thus, tippee liability was established although Rule 10b-5 had not been violated by the tipper, because the tipper had nonetheless violated his fiduciary duty to the shareholders by releasing confidential information. The *Dirks* Court also referred to this section. Dirks v. SEC, 103 S. Ct. 3255, 3261 (1983).

29. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969), *cert. denied*, 404 U. S. 1005 (1971).

30. *Texas Gulf*, 401 F.2d at 839-40.

31. *Id.* at 848; *see supra* note 20.

32. *Texas Gulf*, 401 F.2d at 848 (anyone possessing material inside information is restrained by the duty to disclose or abstain) (dictum).

33. *Id.* Although two of the defendants passed information to tippees, who subsequently purchased Texas Gulf Sulphur stock, the tippees were not defendants in the case. The court noted that although the tippees' conduct "could be equally reprehensible," it was not within the purview of the opinion. The tippers, however, were held liable for their gratuitous tips. *Id.* at 852-53. *Texas Gulf* was the first case to hold that tipping violated Rule 10b-5. 3 A. BROMBERG & L. LOWENFELS, *supra* note 13, § 7.5(3)(a).

34. *See* Langevoort, *supra* note 17, at 10.

cated that a corporate fiduciary's Rule 10b-5 obligations passed to the tippee anytime the insider revealed information to the tippee.[35] The tippee breached this "inherited" fiduciary duty whenever he knowingly traded on the basis of the information, or transmitted the inside information to someone likely to trade on its basis.[36] The uncertainty surrounding tippee liability was compounded by the absence of any well-defined precedents concerning the nature of the insider's duty as a fiduciary under Rule 10b-5.[37]

Decisional law indicated that an insider's duty to disclose or abstain was based upon the possession of material, nonpublic information rather than the insider's fiduciary duty to the shareholders. The equitable principle of fairness that underlay this rationale was, by implication, similarly applicable to tippees. In adopting this theory as the basis of the disclosure obligation, the Second Circuit in *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[38] found that tippee liability was determined independently from the liability of the tipper. In *Shapiro*, the prospective underwriter of a new issue of securities disclosed material, adverse information regarding the issuer's earnings to several of its customers. The customers, most of whom were institutional investors, subsequently sold 165,000 shares of the stock on a national exchange.[39] In finding that the disclosing underwriter and the selling customers knew that the adverse earnings information was confidential, the Second Circuit held that both the non-trading tippers and the trading tippees violated Rule 10b-5.[40] The broad theory of insider liability set forth in *Texas Gulf*, requiring disclosure or abstention by anyone pos-

35. *See* Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 890 (2d Cir. 1972) (one in possession of material inside information, be he an insider or a tippee, must disclose or abstain); 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 subject to the same duty as insiders").

36. *See* Dirks v. SEC, 103 S. Ct. 3255, 3261-62 (1983). The SEC adopted this position in *Dirks*.

37. *See supra* note 20 and accompanying text. Courts have yet to define clearly the term "fiduciary." A fiduciary duty exists when there is an expectation of trust and confidence created by the relationship or when the law implies this expectation. *See generally* Scott, *The Fiduciary Principle*, 37 CALIF. L. REV. 539 (1949) (discussing the nature of a fiduciary relationship).

38. 495 F.2d 228 (2d Cir. 1974).

39. *Id.* at 231-33. The shares sold by the tippees constituted one-half of the total number of the issuer's shares sold during this time period, and the sales precipitated a "sudden and substantial" drop in the price of the security.

40. *Id.* at 237-38. The underwriter and the individual officers involved in the disclosure received compensation from the execution of the sell orders in the form of commissions and "give-ups"—a percentage of the commissions earned by other brokers who executed sale orders for the institutional investors. It is significant that the court did not base the non-trading tippers' liability on personal gain. The *Shapiro* court referred to *Texas Gulf*, where tippers were found liable under Rule 10b-5 for gratuitous tipping. *Id.* at 239; *see supra* note 33.

sessing material inside information, was construed to include tippees.[41] In holding that the tippee's disclosure obligation was determined independently, the *Shapiro* court emphasized that the congressional purpose behind section 10(b) was to ensure that all investors have "relatively equal access to material information."[42]

Decisional law delineating both insider and tippee liability focused on the trading party's access to material, nonpublic information. Courts did not inquire into the relationship between the tippee and the shareholders who were disadvantaged by the trading. Therefore, any rule determining tippee liability was predicated upon establishing the basis of the insider's duty to disclose or abstain. The Supreme Court first explored the relationship between the insider's fiduciary duty to the shareholders and the Rule 10b-5 disclosure duty[43] in *Chiarella v. United States*.[44] Although *Chiarella* did not involve an insider or a tippee, the Court examined the source of the duty to disclose or abstain and held that mere possession of material, nonpublic information did not require disclosure.[45] In *Chiarella*, a financial printer prepared announcements of corporate takeover bids. Although the names of the target companies were not revealed to the printer until the final printing, an employee of the printer deduced the company names from other information in the announcements.[46] The employee's purchases and resales of the target company's securities were held not to constitute fraud under Rule 10b-5 because the employee was not an insider of the target company. Furthermore, the employee did not receive any information from the target company and hence was not placed in a position of trust and confidence,[47] creating obligations similar to those imposed on a fiduciary. The *Chiarella* Court expressly rejected regular access to information as the basis for the obligation to disclose or abstain.[48] Mere possession of nonpublic market information was deemed

41. *Shapiro*, 495 F.2d at 236. The implicit assumption in the decision is that the underwriter was an insider.
42. *Id.* at n.13 (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), *cert. denied*, 404 U.S. 1005 (1971)). The *Shapiro* court deemed it immaterial that a private damages action was involved, rather than an SEC injunction action.
43. Langevoort, *supra* note 17, at 3.
44. 445 U.S. 222 (1980).
45. *Id.* at 235.
46. *Id.* at 224.
47. *Id.* at 231-33. The disclose or abstain rule applies to other relationships of trust besides that of a fiduciary. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (employees of a bank acting as stock transfer agents for Indian tribe); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) (registered investment advisor); Zweig v. Hearst Corp., 594 F.2d 1261 (9th Cir. 1979) (financial columnist).
48. *Chiarella*, 445 U.S. at 235-37. The Court did not decide whether the employee violated a duty as an agent of the offeror corporation by misappropriating confidential information for personal profit because that theory had not been included in the jury instructions. This theory is difficult to apply to tippees because the persons who are disadvantaged by the trading, those "who purchase or sell in

insufficient to impose a Rule 10b-5 obligation to disclose or abstain;[49] instead, a party must first establish a relationship of trust and confidence between the trading parties.[50]

In a departure from the trend in prior decisional law, *Chiarella* cast doubt upon the judicial assumption that anyone who knowingly received inside information from an insider "inherited" the insider's fiduciary duty to disclose before trading.[51] Although tippee liability was not at issue in *Chiarella*, its holding obviated the rule previously set forth by the Second Circuit that a disclosure duty arose whenever material, nonpublic information was obtained by virtue of a position affording access to this information. By requiring that a relationship similar to that of a fiduciary exist before the disclosure obligation could be implicated, it was uncertain what else besides "mere possession" would be required to impose tippee liability. Tippees do not generally have a prior relationship of trust or confidence with the corporate shareholder, and therefore the analytical basis for imposing a disclosure duty upon tippees was placed in issue.

In *Dirks v. SEC*,[52] the Supreme Court held that in the absence of a breach of the insider's fiduciary duty to disclose or abstain, the analyst tippee was not obligated to disclose the inside information before trading.[53] The Court rejected the SEC's argument that a tippee "inherited" a duty to disclose whenever he knowingly received inside information as inconsistent with the requirement of a confidential relationship in *Chiarella*.[54] The SEC's position was equated with the proposition that

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connection with the security," are not only those shareholders whose information is misappropriated. *Id.*

49. *Id.* at 235. The narrowness of the holding is significant, because *Chiarella* does not affirmatively establish how much more than "mere" possession is required to create a disclosure obligation.

50. *Id.* at 230. The Court's discussion concerning tippee liability, which was relegated to a footnote, stated in part:

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

Id. at 230 n.12 (citations omitted) (dictum).

51. *See supra* notes 36-37 and accompanying text. The variety of legal theories thought to underlie the disclosure obligation was reflected in the four opinions issued in *Chiarella*. The two concurring opinions and one dissenting opinion indicated varying degrees of support for the misappropriation theory, while another dissenting opinion advocated the Second Circuit's "regular access to inside information" theory. The latter was based on a trend in tort law that considered the existence of "special facts" as a reason for imposing a duty to disclose in an action for fraud when a confidential or fiduciary relationship is involved. *Chiarella*, 445 U.S. at 237-53 (Stevens, J., concurring) (Brennan J., concurring) (Burger, C.J., dissenting) (Blackman, J., dissenting); *see supra* note 20.

52. 103 S. Ct. 3255 (1983).

53. *Id.* at 3265.

54. *Id.* at 3261-63.

Rule 10b-5 requires equal information among all traders, a view that conflicted with *Chiarella*'s directive that not all persons trading on inside information were subject to the duty to disclose.[55] After emphasizing that market analysts contribute to the preservation of a healthy securities market by "ferreting out" information, the Court cautioned that imposing Rule 10b-5 liability on all recipients of material, nonpublic information could inhibit the role of analysts in fulfilling a legitimate and necessary market function.[56]

The Court referred to its statement in *Chiarella* that tippee liability arose from the tippee's role as a participant after the fact and concluded that the tippee's duty to disclose is derivative from the breach of the insider's disclosure duty.[57] The *Dirks* Court interpreted the *Cady, Roberts* insider trading requirement of a relationship affording access to inside information to mean the tippee must assume a fiduciary duty to the shareholders before incurring liability.[58]

The *Dirks* Court delineated a two factor test to determine when tippees must assume a fiduciary duty to disclose or abstain from trading. First, an insider must breach his fiduciary duty to the shareholders by disclosing the information, and second, the tippee must know or have reason to know that there has been a breach.[59] The Court, however, noted that not all breaches of fiduciary duty in connection with a securities transaction constitute fraud under Rule 10b-5.[60] The majority reasoned that fraud requires deception or manipulation, and in the insider trading context the deception lies in the unfairness that results when inside information is used for personal profit by one who knows the information is confidential. The *Dirks* Court thus concluded that an insider breaches his fiduciary duty by tipping only when he benefits from the disclosure.[61] The tipping by the former officer and other employees was aimed at revealing the fraudulent practices. The majority reasoned that the tippers did not intend to profit from the tip, and consequently they did not violate their fiduciary duty to the corporation's shareholders. The analyst, therefore, as tippee, did not acquire a derivative duty to disclose or abstain.[62]

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55. *Id.* at 3262. Market professionals are exempt from the prohibition against members of national securities exchange trading for their own accounts. Securities Act of 1933, 15 U.S.C. § 78k(a)(1) (1982). This exemption was cited as evidencing Congress' intent not to require parity of information among investors. *See* Chiarella v. United States, 445 U.S. 222, 233-34 n.16 (1980) ("the exception is based upon Congress' recognition that [market professionals] contribute to a fair and orderly marketplace . . . .").
56. *Dirks*, 103 S. Ct. at 3263.
57. Chiarella v. United States, 445 U.S. 222, 230 n.12 (1980).
58. *Dirks*, 103 S. Ct. at 3261.
59. *Id.*; *see* A. JACOBS, THE IMPACT OF RULE 10b-5 § 167 (1975).
60. *Dirks*, 103 S. Ct. at 3258; *see* Santa Fe Indus. v. Green, 430 U.S. 462 (1977); United States v. Dixon, 536 F.2d 1388 (2d Cir. 1976).
61. *Dirks*, 103 S. Ct. at 3260.
62. *Id.* at 3263-65. The Court also held that the analyst was not an insider since he

Courts have traditionally construed the antifraud provisions of the federal securities acts broadly in light of their remedial purposes, and therefore have not strictly adhered to the technical requirements of common law fraud.[63] The principle of equitable fraud, which is based on general considerations of fairness rather than specific elements, has been applied in SEC enforcement actions brought under the federal antifraud provisions.[64] The expansive application of the antifraud provisions is partially attributable to a recognition that the common law doctrine of fraud developed in personal transactions involving tangible commodities, and is unsuited to transactions dealing with intangible securities, which are often traded anonymously through national exchanges.[65] *Dirks* departs from the trend in prior tippee trading cases, which liberally imposed tippee liability based upon general notions of fairness.[66] The tipper's breach of fiduciary duty was formerly relevant in tippee liability cases for determining the existence of scienter on the part of the tippee.[67]

The premise underlying the majority decision, that the fraudulent act in tippee trading must necessarily be committed by the tipping insider, is analytically unsound and produces inconsistent results. The majority acknowledges that the prohibition against insider trading derives from a judgment that this trading is unfair.[68] This conclusion is in accordance with the common law doctrine of equitable fraud in that its

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did not induce the shareholders or officers of the defrauding company to place their trust or confidence in him. The tippers were never charged by the SEC. *Id.*

63. *See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963)); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 235 (2d Cir. 1974).

64. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 192-94 (1963). One commentator explained that "[f]raud has a broader meaning in equity . . . and intention to defraud or misrepresent is not a necessary element." W. DE FUNIAK, HANDBOOK OF MODERN EQUITY 235 (2d ed. 1956) (quoted in *Capital Gains*, 375 U.S. at 193). Thus, materiality substitutes for reliance, and privity is not required. *See Capital Gains*, 375 U.S. at 198-201; A. BROMBERG & L. LOWENFELS, *supra* note 13, §§ 8.6-8.7(2) (1979).

65. *See* SEC v. Capital Gains Research Bureau, Inc., 306 F.2d 606, 614 (2d Cir. 1962) (Clark, J., dissenting). *See generally* Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 227-30 (1933) (common law of tort and contract applied piecemeal to securities transactions; a comprehensive underlying policy was rarely articulated).

66. *See supra* notes 35-38 and accompanying text. *Dirks* is consistent with the holding in *Chiarella* that a position affording access to material, nonpublic information suffices as a basis for imposing Rule 10b-5 liability. *See* Chiarella v. United States, 445 U.S. 222, 235-37 (1980).

67. *See* Dirks v. SEC, 681 F.2d 824, 844 (D.C. Cir. 1982), *rev'd*, 103 S. Ct. 3255 (1983); Investors Research Corp. v. SEC, 628 F.2d 168, 178 (D.C. Cir.), *cert. denied*, 449 U.S. 919 (1980); Woodwarth v. Metro Bank of Dallas, 522 F.2d 84, 94 (5th Cir. 1975); *In re* Investors Management Co., 44 S.E.C. 633, 641 (1971); *supra* note 27.

68. *See* Dirks v. SEC, 103 S. Ct. 3255, 3261 (1983) (quoting *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 936 (1968)).

primary goal is to prevent overreaching.[69] The insider's purpose in tipping, however, is not what renders tippee trading unfair. The unfairness inheres in the tippee's manipulation[70] of confidential information by trading in the corporation's securities. Only then are persons who trade "in connection with the purchase or sale" of the security disadvantaged by the tippee trading.[71] In *Dirks* the inside information was lawfully obtained by the tippee, but was unfairly used to allow the institutional investors to unload worthless stock on the investing public. As courts and commentators have recognized, the mere act of tipping without subsequent trading does not violate Rule 10b-5 because no loss is suffered by investors, and therefore there is no deception.[72] In this respect the tippee is the principle wrongdoer and not, as the majority characterizes him, a participant after the fact.[73] Thus, since trading by the tippee is necessary to consummate a violation, the majority's characterization is inaccurate.

The result produced by the rationale in *Dirks* undermines the general objectives of the federal securities law, i.e., protecting the investing public and ensuring the integrity of the securities markets.[74] The

69. *See* Langevoort, *supra* note 17, at 19, 24, 26. Under the proposed Federal Securities Code, tippees are classified as insiders when their relationship to the issuer gives them access to such information or else they receive the information from such a person. FED. SEC. CODE § 1603(b)(3)-(4) (1972); *see* W. PAINTER, THE FEDERAL SECURITIES CODE AND CORPORATE DISCLOSURE § 5.03, at 162-63 (1979).

70. Ironically, the Supreme Court found Congress' use of the word "manipulative" particularly significant in an earlier case when the Court noted that it was a term of art in the securities' vernacular, connoting fraud that is effected through control of security prices. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976).

71. The jurisdictional requirement of Rule 10b-5 prohibits fraudulent practices that are employed "in connection with the purchase or sale of [the traded security]." 17 C.F.R. 240.10b-5 (1983). Thus, defrauded persons with standing may not include the corporate shareholders if they have not bought or sold during the time that the tippee traded on the inside information. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (offerees of a stock offering who were not shareholders and did not purchase stock lacked standing under Rule 10b-5 in action for alleged misrepresentation in the offering prospectus). Arguably, tippee liability should not be predicated on the violation of a fiduciary duty owed to persons not within the aegis of Rule 10b-5.

72. *See* Elkind v. Liggett & Meyers, Inc., 635 F.2d 156, 169 (2d Cir. 1980) (tipping of confidential information violates insider's fiduciary duty, but no injury occurs until the information is used by the tippee); A. BROMBERG & L. LOWENFELS, *supra* note 13, at §§ 7.5(3)(b), .5(4); Langevoort, *supra* note 17, at 25-26. *But see* SEC v. Glen Alden Corp., [1968 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,280 (insiders enjoined from disclosing material inside information, despite absence of tippee trading).

73. *See* Dirks v. SEC, 103 S. Ct. 3255, 3264 (1983) (quoting Chiarella v. United States, 445 U.S. 222, 230 n.12 (1980)). The tipper is more accurately characterized as an aider and abettor. *See In re* Raymond L. Dirks, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,812 (Jan. 22, 1981), *aff'd*, 681 F.2d 824 (D.C. Cir. 1982), *rev'd*, 103 S. Ct. 3255 (1983).

74. *E.g.*, Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 235 (2d Cir. 1974); Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 793 (2d

losses suffered by investors as a result of tippee trading are the same, regardless of the insider's motive for tipping.[75] When multiple tippers and tippees are involved, it is anomalous to impose liability only upon those tippees whose insider sources benefited from tipping, if the tippees themselves are equally culpable. In addition, courts will differ on what benefits tippers, and the tipper's subjective purpose in tipping will be difficult to prove.[76] The dissent argued that the majority implanted a motivational requirement on the fiduciary duty doctrine.[77] In rebutting the majority's interpretation of the law regarding fiduciaries, the dissent drew an analogy to the fiduciary duty of a trustee. The trustee's duty is breached by knowing conduct that causes a loss to the trust, regardless of whether profit accrues to the trustee.[78] Further support for the dissent's approach is found in the rule that a director's fiduciary duty to the shareholders varies, depending upon the substantive law governing the particular fiduciary relation.[79] A tipping insider's breach should be determined by reference to prior decisional law, where tipper liability was premised on whether it was reasonably foreseeable that a disclosure would result in trading by the tippee.[80]

By adopting a standard of tippee liability that is generally unsupported by either prior decisional law[81] or the objectives of the federal

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Cir. 1969), *cert. denied*, 400 U.S. 822 (1970); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 858 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), *cert. denied*, 404 U.S. 1005 (1971).

75. Dirks v. SEC, 103 S. Ct. 3255, 3271 (1983) (Blackmun, J., dissenting).
76. *See id.* at 3272 n.13. Dirks indisputably received compensation in the form of additional clients and enhanced reputation. *Id.* at 3269 n.4. The Court included benefit to reputation as a form of profit that could accrue to the tipper. *Id.* at 3265-66; *see* Brudney, *supra* note 12, at 348. It is arguable that at least the former officer personally benefited from his disclosure since his professional reputation would be enhanced when his role in exposing the fraud was made public.
77. *Id.* at 3270-72 (Blackmun, J., dissenting). Justice Blackmun argued that personal gain by the insider is a result that the securities laws were intended to prevent, rather than an element of a breach of the insider's fiduciary duty. *Id.* at 3269.
78. *Id.* at 3271; *see also* Mosser v. Darrow, 341 U.S. 267, 272 (1951) (trustee liable for allowing employees to possess interests adverse to the trust, even though trustee did not benefit therefrom), *cited in* Dirks v. SEC, 103 S. Ct. 3255, 3271-72 (1983) (Blackmun, J., dissenting). *See generally* RESTATEMENT (SECOND) OF TRUSTS § 170(2) (1959) (trustee is under duty to deal fairly with beneficiary and to act for his benefit).
79. A. SCOTT, SCOTT ON TRUSTS § 495, at 3534 (3d ed. 1967).
80. Elkind v. Liggett & Meyers, Inc., 635 F.2d 156, 167 (2d Cir. 1980); *cf.* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974).
81. *See* Elkind v. Liggett & Meyers, Inc., 635 F.2d 156, 164 (2d. Cir. 1980) ("knowing use by insiders of inside information for their own benefit *or that of tippees* violates Rule 10b-5") (emphasis supplied); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 860 (2d Cir. 1968) ("We do not believe that Congress intended that . . . the Act would not be violated unless [deceptive insider activity] was motivated by a plan to benefit the corporation or themselves"), *cert. denied*, 394 U.S. 976 (1969), *cert. denied*, 404 U.S. 1005 (1971). *But see* Chiarella v. United States, 445 U.S. 222, 230 n.12 (1979). As cogently noted by the dissent in *Dirks*, the only support cited in *Chiarella* for the proposition that tippee liability arises from a tippee's role as a participant after the fact is an ABA Comment Letter. *Id.* (citing SUBCOMMIT-

securities laws, *Dirks* appears to represent an effort to limit jurisdiction under Rule 10b-5.[82] The *Dirks* decision immunizes a large class of trading tippees, including professional analysts and ordinary investors, who profit from the use of confidential information obtained by means other than "diligence and acumen."[83] Perhaps Congress will eventually prohibit tippee trading expressly to close the gap left open by the Court's holding.[84]

Nancy I. Knapp

TEE OF ABA SECTION OF CORPORATION, BANKING, AND BUSINESS LAW, COMMENT LETTER ON MATERIAL, NON-PUBLIC INFORMATION (Oct. 15, 1973), *reprinted in* SEC. REG. & L. REP. (BNA) Report No. 233, at D-1, D-2 (Jan. 2, 1974)).

82. *See Dirks*, 103 S. Ct. at 3268 (Blackmun, J., dissenting).

83. *See* Chiarella v. United States, 445 U.S. 222, 252 n.2 (1980) (Blackmun, J., dissenting).

84. Subsequent to *Chiarella*, Congress enacted Rule 14e-3 under section 14(e) of the 1934 Act. This rule prevents anyone from using inside information that is acquired from a representative of either the target or offeror in a tender offer. 17 C.F.R. § 240.14e-3 (1983).