Duquesne Law Review

Volume 23 | Number 2 Article 10

1985

Securities Exchange Act of 1934 - SEC Rule 10B-5 - Insider Duty - Third Party Duty

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Securities Exchange Act of 1934—SEC Rule 10b-5—Insider Duty—Third Party Duty—The Supreme Court of the United States has held that before a third party inherits a duty to disclose material non-public information or refrain from trading, an insider must first breach a specific fiduciary duty.

Dirks v. Securities and Exchange Commission, 103 S. Ct. 3255 (1983).

In 1973, the Securities and Exchange Commission (SEC) investigated the role of Raymond Dirks, an officer in a New York broker-dealer firm, in alleged security law violations.[1] Dirks' firm analyzed insurance companies for investment purposes.[2] Dirks had learned from Ronald Secrist, a former officer of Equity Funding of America, that Equity Funding was fraudulently inflating its assets.[3] Secrist then urged Dirks to investigate, verify, and disclose the fraud.[4] Dirks conducted his own investigation and discovered fraud.[5] He then informed the Wall Street Journal which, fearing a libel action, refused to publish the information.[6]

During the course of Dirks' investigation, Equity Funding stock fell from $26 per share to $15 per share and the New York Stock Exchange halted trading in the stock on March 27, 1973.[7] Subsequently, California insurance authorities impounded Equity Funding's records and discovered the fraud.[8] This prompted the SEC to file a complaint against Equity Funding and the Wall Street Journal to publish a front page story.[9]

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1. Dirks v. SEC, 103 S. Ct. 3255, 3258 (1983).
2. *Id.* at 3258.
3. *Id.*
4. *Id.* Secrist informed Dirks that various regulatory agencies had failed to act upon reports by Secrist and others. *Id.*
5. *Id.* at 3258 & nn.1 & 2. Dirks openly discussed the fraud with clients and other investors. Relying on this information, Dirks' clients and others liquidated their holdings. Five investors liquidated a total of $16 million worth of stock. It was unclear whether Dirks received any compensation or brokerage business from those to whom he conveyed the information. *Id. See* Dirks v. SEC, 21 S.E.C. 1401, 1402-06 (1981).
6. 103 S. Ct. at 3258. Dirks contacted the Wall Street Journal's Los Angeles bureau chief, William Blundell, who did not believe that such a massive fraud could go undetected and refused to publish the story. *Id.*
7. *Id.*
8. *Id.* at 3258-59 & n.3.
9. *Id.* at 3259. Equity Funding went into receivership and 22 persons, including many Equity Funding officers, were indicted. *Id.* at 3259 & n.4.

The SEC held a hearing before an administrative law judge in order to determine what role Dirks played in the exposure of the fraud.[10] The SEC found that although neither Dirks nor his firm traded in Equity Funding stock, Dirks had repeated information concerning the fraud to investors who then sold their Equity Funding stock in violation of SEC regulations and relevant statutes.[11] Since Dirks had helped to expose the fraud, however, he was only censured by the SEC.[12]

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10. *Id.* at 3259.

11. *Id.* at 3258-59. The SEC concluded: "Where 'tippees'—regardless of their motivation or occupation—come into possession of material 'information that they know is confidential and know or should know came from a corporate insider,' they must either publicly disclose that information or refrain from trading." *Id.* at 3259. Dirks was indicted for violating section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) (1982), which provides in pertinent part:

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

15 U.S.C. § 77q(a)(1982).

Dirks was also indicted under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b)(1982), which 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 . . .
> (b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b)(1982).

In addition, Dirks was found to have violated SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1982), which 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 national securities exchange,
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1982).

12. 103 S. Ct. at 3259-60. While censure implies no punitive action, the actual effect may be substantial injury to one's reputation. The SEC has broad powers to regulate dealers in securities and discretion in imposing sanctions for violations. *See* 15 U.S.C § 78o(c); 17 C.F.R § 240.15b7-1.

Dirks appealed his censure to the Court of Appeals for the District of Columbia Circuit,[13] which upheld the SEC decision and entered judgment against Dirks.[14] The Supreme Court then granted certiorari and reversed.[15]

Justice Powell delivered the opinion of the Court,[16] noting that there was no general duty of a corporate insider to disclose material non-public information or to refrain from trading on such information until it becomes public.[17] Further, he noted that there was no derivative duty in a third party, the breach of which would render the third party liable.[18] Instead, according to Justice Powell, an insider must breach a fiduciary duty before a third party inherited a duty to disclose the information or to refrain from trading in the security.[19]

Justice Powell arrived at his conclusion by relying on several landmark cases, most notably *Chiarella v. United States*,[20] in which it was held that there was no general duty to disclose material information before trading.[21] In *Chiarella*, Justice Powell explained, the Supreme Court recognized the SEC application of the common law rule which places an "affirmative duty" on corporate insiders to disclose.[22] The SEC had adopted the common law standard and found that a breach of the fiduciary duty owed by corporate insiders to shareholders established the elements of a violation of Rule 10b-5.[23] Additionally, Justice Powell continued, the SEC

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

14. *Id.* at 839. Judge Wright held that "the obligations of corporate fiduciaries pass to all those to whom they disclose their information before it has been disseminated to the public at large", *id.* at 839, and that "Dirks had violated '[o]bligations to the SEC and to the public completely independent of any obligations he acquired' as a result of receiving the information." *Id.* at 840.

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

16. 103 S. Ct. at 3260. Justice Blackmun, with whom Justices Brennan and Marshall joined, dissented. *Id.* at 3268.

17. *Id.* at 3261. *See Dirks*, 681 F.2d 824, 837-40 (D.C. Cir. 1982).

18. 103 S. Ct. at 3260.

19. *Id.* at 3270.

20. 445 U.S. 222 (1980).

21. 103 S. Ct. at 3260-61. In *Chiarella*, the court set forth two elements of a Rule 10b-5 violation: "(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure." 445 U.S. at 227.

22. 103 S. Ct. at 3260. Corporate insiders are usually considered to be officers, directors, or controlling stockholders in a corporation. *See In re* Cady, Roberts & Co., 40 S.E.C. 907 (1961) (applying the common law standard of fiduciary duty owed by persons other than corporate insiders).

23. 103 S. Ct. at 3260. *See Cady, Roberts*, 40 S.E.C. at 907.

applied the same standard to individuals other than corporate insiders who would also be required to either disclose material nonpublic information or refrain from trading.[24] The *Chiarella* Court held that no duty to disclose arose from "mere possession" of material information, but, rather, from a fiduciary relationship.[25] Even where a fiduciary relationship existed, Justice Powell explained, there could be no violation absent the additional element of "manipulation or deception."[26]

The *Dirks* Court next addressed the SEC argument that a tippee inherits the duty which a corporate insider owes to the corporate shareholders.[27] The rationale upon which the SEC based its position, and which the Court in *Chiarella* had rejected, was the "information theory."[28] The *Chiarella* Court had rejected the "information theory" on the basis that, if adopted, it would inhibit the significant role of market analysts.[29] The *Dirks* Court again declined to adopt this expansive interpretation of Rule 10b-5.

Justice Powell next addressed the need for some ban on tippee trading, and recognized that insiders cannot use tippees as a shield to hide their personal gain.[30] The Court stated that those who knowingly participate with a fiduciary in the fiduciary's breach stand on the same footing as the fiduciary.[31] The Court concluded that the tippee's duty is derivative of the insider's duty and that

24. 103 S. Ct. at 3260. *See, e.g., In re* Faberge, Inc., 45 S.E.C. 249, 256 (1973).

25. 103 S. Ct. at 3260-61.

26. *Id.* (citing Santa Fe Industries v. Green, 430 U.S. 462 (1977)). The *Santa Fe* court held that there must be an element of fraud involved in order to prevent the unfairness inherent in allowing certain individuals to act on information intended for corporate purposes only. The Court in *Dirks* stated that " '[n]ot all breaches of fiduciary duty in connection with a securities transaction,' however, come within the ambit of Rule 10b-5 . . . . There must also be manipulation or deception." 103 S. Ct. at 3261 (citing *Santa Fe*, 430 U.S. at 462). *See also In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 936 (1968).

27. 103 S. Ct. at 3261-62.

28. *Id.* The "information theory" is based upon the premise that all traders are entitled to equal information before trading. This theory was specifically rejected in *Chiarella*, where the court stated that "[a] duty [to disclose] arises from the relationship between the parties . . . and not merely from one's ability to acquire information because of his position in the market." *Id.* at 3263. (quoting *Chiarella*, 445 U.S. at 232-33 n.14).

29. 103 S. Ct. at 3263. *See supra* note 17.

30. 103 S. Ct. at 3263. The Court held that it is "unlawful to do indirectly 'by means of any other person' any act made unlawful by federal securities laws." *Id.* (quoting 15 U.S.C. § 78f(b)). *See supra* note 11.

31. 103 S. Ct. at 3263 (citing Mosser v. Darrow, 341 U.S. 267 (1951)). *Mosser* held that a trustee is liable for the inside trading of his employees despite the fact that the trustee himself neither obtained a profit nor exhibited any bad purpose. 341 U.S. at 272.

the tippee's duty rests on improperly received information.[32] Thus, the Court held, a tippee inherits a duty to a stockholder to either disclose material information or to refrain from trading only when the insider has breached his fiduciary duty *and* when the tippee knows or should know that a breach has occurred.[33]

The Court next addressed the issue of whether an insider's "tip" constituted a breach of fiduciary duty. The Court defined "breach" by first identifying the purpose of the disclosure or "tip."[34] Relying on the SEC's self-imposed standard, announced in *In re Cady, Roberts*, the Court held that the insider must obtain some personal advantage for a breach to occur.[35] Absent a personal advantage to the insider, either direct or indirect, there can be no breach of fiduciary duty to the stockholders. The Court further stated that if there is no breach by the insider, there can be no derivative breach by the tippee.[36]

In summarizing the majority position, Justice Powell reasoned that for a Rule 10b-5 violation to arise, an insider must be in a fiduciary relationship which creates a duty to disclose.[37] Further, the Court stated that the insider must breach the duty by an intentional or willful "manipulation or deception" (fraud), which is determined by the objective standard of personal gain for the insider.[38] To hold otherwise, the Court reasoned, would make it difficult for practitioners to decide whether their contemplated actions would violate Rule 10b-5, and could lead to liability for every person who may have come across inside information.[39] The Court indicated that allowing liability for innocent disclosures, and for disclosures made in the public interest, would eliminate the element of "intent" and impose strict liability, a result not warranted by the language of the statute.[40]

32. 103 S. Ct. at 3264. "Improper" is defined as a violation of a *Cady, Roberts* duty. *Id.*

33. *Id.*

34. *Id.* at 3265. The Court indicated that not all "tips" were breaches of the duty. As an example, Justice Powell pointed out that it may be unclear to both the insider and tippee whether the information is material and non-public. *Id.*

35. *Id. See Cady, Roberts*, 40 S.E.C. at 912 n.15.

36. 103 S. Ct. at 3265.

37. *Id.* at 3266-67.

38. *Id.* at 3265-67. The SEC argued that to determine a fraudulent purpose would require the courts to read a party's mind. But Justice Powell held that an objective standard would be used by looking for a "pecuniary gain or reputational benefit that will translate into future earnings." *Id.* at 3266.

39. *Id.* at 3266 & n.24.

40. *Id.* at 3266. *See supra* note 11.

Finally, the Court reasoned that because Secrist's purpose was to expose fraud and not to achieve personal gain, he did not breach a fiduciary duty. Therefore, there could be no derivative breach by Dirks, and he was held not to have violated Rule 10b-5.[41]

In his dissent, Justice Blackmum strongly disagreed with the *Dirks* majority since, in his view, the holding further limited investor protection.[42] Justice Blackmun especially decried the "innovation" that an insider must act out of a desire for personal gain in order to create a breach of duty.[43] The dissent regarded Secrist's actions in providing Dirks with the information as intending to harm the purchasers of Equity Funding securities, to whom he owed a duty to disclose.[44] Justice Blackmun further disagreed with the majority's view that Secrist did not breach his duty because he did not have the improper purpose of personal gain. Justice Blackmun then asserted that stockholders other than Dirks' clients, as well as future purchasers of Equity Funding stock, were unfairly harmed.[45] The dissent, therefore, concluded that although an insider may not personally benefit, the corporation's stockholders may nevertheless be harmed, and that a breach of duty still existed.[46] Justice Blackmun thus refused to take part in the majority's "limitation of the scope of an insider's fiduciary duty to

41. 103 S. Ct. at 3267-68.

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

43. *Id.*

44. *Id.* at 3270. Justice Blackmun emphasized that Secrist provided Dirks with the information in order for Dirks to disseminate it to his clients, hoping to trigger a steep drop in Equity Funding securities, and to prompt reaction by the authorities. This is exactly what occurred when Dirks disseminated the information to his clients and undertook his own investigation. Justice Blackmun also believed that Dirks selectively disseminated the information to his clients before informing either the authorities or the Wall Street Journal, the effect of which was to enable Dirks' clients to mitigate their losses. The dissent considered important the fact that Dirks gave the "hard" story—all the facts—to those holding Equity Funding securities. To others, he gave a vague set of facts, apparently to enable his clients to dump their Equity Funding stock. Therefore, Justice Blackmun concluded that Dirk's clients obtained an unfair advantage over all other Equity Funding stockholders. *Id.* at 3268-69 nn.3 & 4.

45. *Id.* at 3270.

46. *Id.* at 3270-71. *See generally id.* nn.9-11. The fact that in most cases the insider does benefit was thought not to be controlling by Justice Blackmun, who maintained that "personal gain" was *not* an element of breach of this duty: "The duty is addressed not to the insider's motives, but to his actions and their consequences on the shareholder. Personal gain is not an element of the breach of this duty." *Id.* (footnote omitted). The dissent relied on Aaron v. SEC, 446 U.S. 680 (1980), which held that a 10b-5 violation must include the requisite scienter. One breaching the duty must know or intend that his conduct would violate the duty. *Id.* Justice Blackmun maintained, however, that the scienter requirement addresses intent, not motives behind the intent, and Secrist knew and intended that his actions would enable Dirks to cause trading. 103 S. Ct. at 3270-71.

shareholders."[47]

Continuing his dissent, Justice Blackmun described the majority as having weighed the public benefit derived from Secrist's violation of his duty to shareholders against the harm caused to the shareholders.[48] Disagreeing with the Court's conclusion, he maintained that even if both Dirks' and Secrist's motives were pure, neither they nor their clients should benefit from the disclosure.[49] Acknowledging that the SEC had yet to establish an adequate policy for disclosure procedures, Justice Blackmun nonetheless would have held that Secrist breached his duty to the stockholders, and that therefore Dirks derivatively breached the same duty.[50]

Violations of section 10(b) and Rule 10b-5 may be discerned by construing the language of the statute itself.[51] It was agreed by both the majority and the dissent in *Dirks* that scienter is required as an element of any Rule 10b-5 violation.[52] However, central to the issue in *Dirks* was whether fraud is a necessary part of scienter, without which there can be no violation of the rule. In examining the pertinent statutes, it becomes apparent that one must both possess the requisite scienter *and* intend to commit fraud in some manner.[53]

The dissent in *Dirks,* however, argued the opposite. Justice Blackmun maintained that fraud is not a requisite part of scienter and that simply intending the result or possessing the knowledge that the result will occur is enough to incur liability.[54] Justice Blackmun considered fraud to be a reflection of the motives of an individual, while scienter concerns itself only with knowledge or

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47. *Id.* at 3272.

48. *Id.* at 3273. Justice Blackmun stated that the majority weighed the public benefit brought about by the disclosure against the harm to individual stockholders, and stated that the majority did not find that Dirks violated Rule 10b-5 because "the end justified the means." *Id.*

49. *Id.*

50. *Id.* at 3273-74 & n.17. According to Justice Blackmun, the SEC presently informs market participants that inside information cannot be traded upon before disclosure, yet the Commission has failed to set standards concerning the required *method* of such disclosure. The Court characterized this state of affairs as a "less than sensible policy, which it is incumbent on the Commissioner to correct." *Id.* at 3273.

51. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975) (Powell, J., concurring).

52. *See* 103 S. Ct. at 3265, at 3271 n.10 (Blackmun, J., dissenting). Scienter is generally regarded to be a mental state requiring intent or knowledge. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976). *See also* Aaron v. SEC, 446 U.S. 680, 691 (1980).

53. *See supra* note 11. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1982), provides in part that "it shall be unlawful . . . (a) to employ any device, scheme or artifice to defraud, ..." *Id.*

54. 103 S. Ct. at 3271 & n.9.

intent.[55] Consequently, under Justice Blackmun's analysis, a Rule 10b-5 violation may occur where one's purpose is disinterestly motivated, but one possesses knowledge that the involved actions are violative of the statute.[56]

Conversely, Justice Powell relied on the meticulous analysis of the legislative history conducted by the Court in *Ernst & Ernst v. Hochfelder*.[57] The *Hochfelder* Court had examined the Senate Report and found that section 10(b) of the 1934 Act was directed toward manipulative and deceptive practices—specifically, fraud.[58] The Court quite correctly concluded that Congress did not intend liability under Rule 10b-5 to arise unless a lack of good faith was involved.[59] The conclusion is inescapable, then, that while it is agreed that Rule 10b-5 is a catchall for securities violations, *fraud* must always be found.[60]

It may be noted, however, that commentators have argued that the philosophy upon which the *Dirks* rule rests stems from economic concerns.[61] These commentators would minimize the Court's policy of narrowly construing the statutory language of Rule 10b-5 and maximize the Court's brief statement concerning market analysts.[62] From this latter statement, a theory has developed that the Court arrived at its decision primarily because of its concern with the economic welfare of the market.[63] This interpretation, however, reads too much into the majority's rationale. It is evident from the *Hochfelder* Court's analysis of the legislative history of Rule 10b-5, and from the Court's narrow construction in *Chiarella* and *Dirks*, that the Court is attempting to place the onus on Congress to extend liability if it wishes to do so.

The next step in the analysis of Rule 10b-5 violations is to deter-

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55. *Id.* at 3271 n.10.

56. *Id.* at 3271-72.

57. 425 U.S. 185.

58. *Id.* at 202. The Senate Report concerning the 1934 Act states that section 10(b) was "aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function." S. REP. No. 792, 73d Cong. 2nd Sess. 6 (1934).

59. 425 U.S. at 206. *See also* Santa Fe Industries v. Green, 430 U.S. 462, 472-74 (1977) (holding that only conduct involving manipulation or deception is reached by section 10(b) or Rule 10b-5).

60. 425 U.S. at 202-03. *See also Chiarella*, 445 U.S. at 222 (stating that what the catchall provision "catches" must be fraud).

61. Note, *Dirks v. SEC: A Gain for Dirks, A Loss for the Market*, 35 MERCER L. REV. (1984) 981, 999-1003. The authors base their argument on a sentence in *Dirks* which states that the role of market analysts must be encouraged in order to preserve a healthy market. *Id.* at 1000.

62. *Id. See supra* text accompanying note 29.

63. Note, *supra* note 61, at 1000.

mine whether fraud actually did occur. The *Dirks* Court decided that fraud occurred when a fiduciary duty is breached,[64] and thus it becomes apparent that a duty must be established, and then breached, before a Rule 10b-5 violation arises.[65] According to the Court, the duty in question—to either disclose material non-public information or to refrain from trading—arises from a fiduciary relationship.[66] The issue in *Dirks*, therefore, centered upon whether a fiduciary relationship is necessary to establish a duty.

In his dissenting opinion, Justice Blackmun was clearly in favor of imposing a duty on the insider, Secrist, to both the shareholders and future purchasers of Equity Funding stock.[67] Under this standard, when Secrist disclosed the fraud to Dirks he *possessed* the requisite scienter since he knew or intended that Dirks would disclose the information to his clients with the result that shareholders and future purchasers would be harmed.[68] This being the case, Secrist breached his fiduciary duty and Dirks derivatively breached the same duty.[69]

Imposition of such a duty on an insider would require the application of the "information theory" which was explicitly rejected earlier,[70] most notably in *Chiarella,* where the court relied on the *Restatement (Second) of Torts* and an extended line of cases in order to establish the requirement that a fiduciary duty must be present[71] before a 10b-5 violation could occur. The pervasive rationale for this limiting element, however, rests upon the principle

64. 103 S. Ct. at 3261.

65. *Id.*

66. *Id.*

67. *Id.* at 3269.

68. *Id.* at 3268.

69. *See supra* text accompanying note 14.

70. *See, e.g., Chiarella,* 445 U.S. at 232-34 (rejecting the "information theory"). *See supra* note 28 and accompanying text. *See also Santa Fe,* 430 U.S. at 472-74. *See generally Hochfelder,* 425 U.S. 185 (holding that a narrow interpretation of Rule 10b-5 is required, thereby supplying an approach which limits the duty owed to those in a fiduciary relationship).

71. *Chiarella,* 445 U.S. at 228. The duty arises "because of a fiduciary or other similar relation of trust and confidence between them." RESTATEMENT (SECOND) OF TORTS § 551 (2)(a)(1976). *See, e.g.,* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (transfer agent has no duty since there is no fiduciary relationship); Pepper v. Litton, 308 U.S. 295 (1939) (liability of an insider to the corporation based on a fiduciary duty); Strong v. Repide, 213 U.S. 419 (1909) (fiduciary duty exists between corporate insider and shareholder); General Time Corp. v. Talley Industries, Inc., 403 F.2d 159 (2d Cir. 1968), *cert. denied,* 393 U.S. 1026 (1969) (no duty exists between purchaser and seller of stock if there is no fiduciary relationship); Gratz v. Claughton, 187 F.2d 46 (2d Cir.), *cert. denied,* 341 U.S. 920 (1951) (buyer is owed duty by seller in possession of material inside information only in a situation where there is a fiduciary relationship).

of *stare decisis*.[72] That is, there exists a logical progression of cases which led the Court inescapably to its conclusion in *Dirks*.[73] Once the Court had decided that a narrow interpretation of the 1934 Act and Rule 10b-5 was called for by the statutory language and legislative history, the requirement of fraud became and has remained a necessary element in a 10b-5 violation.[74]

The Court next held that for fraud to exist, there must be a breach of fiduciary duty.[75] Applying this analysis to the facts of the case, the Court correctly concluded that Secrist did not breach a duty to anyone with whom he had a fiduciary relationship since he did not profit by trading in the stock or by fraudulently misrepresenting information.[76] As Secrist did not breach a duty, Dirks could not have been found to have breached a derivative duty without the Court overruling years of precedent.

Justice Blackmun would obviously break with precedent by imposing on insiders and tippees a duty to the market itself.[77] Based upon his broad reading of both the 1934 Act and Rule 10b-5, Justice Blackmun has advocated imposition of the "information theory" in order to protect all market investors.[78] Nevertheless, Jus-

72. *Stare decisis* is defined as "[t]o stand by decided cases". The doctrine is based upon the principle that law should be definite to enable one to understand exactly what is proscribed. BLACK'S LAW DICTIONARY 1261 (5th ed. 1979).

73. *See, e.g., Chiarella*, 445 U.S. 222, *Santa Fe*, 430 U.S. 462; *Hochfelder*, 425 U.S. 185 (narrowly interpreting section 10(b) and Rule 10b-5); *Blue Chip Stamps*, 421 U.S. 723 (limiting class of persons who may bring suit in a 10b-5 action). *See also* Touche Ross and Co. v. Redington, 442 U.S. 560 (1979); SEC v. Sloan, 436 U.S. 103 (1978) (requiring a narrow interpretation of Rule 10b-5).

74. *See supra* notes 53, 59-61 and accompanying text.

75. *See supra* note 69 and accompanying text.

76. 103 S. Ct. at 3265.

77. *Id.* at 3272. *See also Chiarella*, 445 U.S. at 245-46 (Blackmun and Marshall, JJ., dissenting) (arguing that Rule 10b-5 does not require a "special relationship" in order to create a duty); *Hochfelder*, 425 U.S. at 215-18 (Blackmun and Marshall, JJ., dissenting) (arguing that intent or "scienter" is not an element of Rule 10b-5); *Blue Chip Stamps*, 421 U.S. at 761-62 (Blackmun, Douglas, and Brennan, JJ., dissenting) (stating that standing to sue should be liberally granted in Rule 10b-5 actions).

78. *Chiarella*, 445 U.S. at 246 (Blackmun, J., dissenting). *See supra* note 28 for discussion of the "information theory." Justice Blackmun has maintained that a duty exists to all investors or potential investors in the market, in *Chiarella* stating that "[t]he Court continues to pursue a course, charted in certain recent decisions, designed to transform 10(b) from an intentionally elastic 'catchall' provision to one that catches relatively little of the misbehavior that all to often makes investment in securities a needlessly risky business for the uninitiated investor." *Id.* Justice Blackmun opposes such a course, asserting that a duty may be breached *without* the actor gaining a benefit or profit. 103 S. Ct. at 3270.

Justice Blackmun's point is well taken, for harm could be caused to those with whom the insider has a fiduciary relationship without the insider himself obtaining benefit. However, the harm is not determinative of the issue since the profit test is the essential factor in tice Blackmun admitted in his dissenting opinion in *Hochfelder* that the Court's opinion proceeded in a logical manner.[79] Indeed, he noted in his *Chiarella* dissent that the derivative obligations of tippees had not been addressed by the Court.[80] In conclusion, then, Justice Blackmun realized that the logical progression of decisions could lead only to one logical result, that at which the Court arrived in *Dirks*.

Justice Blackmun's approach constitutes a more practical point of view than that of the majority. The former approach stems from a perception that there is a certain unfairness in not extending liability under Rule 10b-5 to *anyone* who manipulates the market in *any* way which would result in harm to *any* investor.[81] The approach places great emphasis on the practical consequences of Secrist's and Dirks' acts—that is, the harm caused to purchasers.[82] A simple hypothetical situation has recently been proposed by one commentator which illustrates Justice Blackmun's concern.[83] The result of this plausible scenario would allow a tippee to escape liability while making large profits.[84] Consequently, Justice Blackmun's concern is very well taken. Yet, to find a general duty is not consistent with the language of Rule 10b-5, nor does it effectuate the legislative intent of the 1934 Act.[85] Perhaps the Court did refuse to "grapple with the difficult issues of efficiency and fairness" and in so doing abdicated its responsibility as one commentator

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identifying fraud. There still must be a breach of duty to those to whom a duty is owed. Therefore, even if Secrist acted fraudulently in some manner, it would still have to be established that he had a duty, based on a fiduciary relationship, to those defrauded.

79. 425 U.S. at 216. Justice Blackmun stated that "[t]he Court's opinion, to be sure, has a certain technical consistency about it." *Id.*

80. 445 U.S. at 246 n.1.

81. *See, e.g., Chiarella*, 445 U.S. at 247-49 (Blackmun, J., dissenting); *Hochfelder*, 425 U.S. at 216-17 (Blackmun, J., dissenting) (advocating extension of Rule 10b-5 to negligent acts).

82. 103 S. Ct. at 3271. The "fairness" Justice Blackmun discussed is open to different interpretations, however. While "fairness" may seem to be a good idea, it would also seem too nebulous a term and present the courts with great difficulty in interpretation. *See* Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 323-30.

83. *The Supreme Court, 1982 Term*, 97 HARV. L. REV. 286, 293 (1983). The scenario proceeds as follows: The president of a corporation tips a friend about an impending tender offer to a target corporation. The tippee then buys and later, after the announced offer, sells stock in the target corporation. Neither the president nor the tippee would be liable under the *Dirks* rule. The president owes no fiduciary duty to the target corporation. Therefore, the tippee could not breach a duty since any duty he may have is derivative. *Id.* at 293.

84. *Id.*

85. *See supra* notes 53, 59-61 and accompanying text.

has suggested.[86] Such judicial restraint, however, is to be applauded. Issues such as "efficiency and fairness" reflect policy decisions which should not be effected through judicial interpretation, but rather should and must be addressed by Congress. As this same commentator has concluded, these policy decisions are best resolved by the legislative branch of government.[87]

In addition to being an unwarranted instance of judicial activism, to impose such a theory at this late date would overturn years of precedent. Having once narrowly construed the intent of Congress in enacting section 10(b) and SEC Rule 10b-5, the decision in *Dirks* was predictable and inevitable.[88] Given the trend of Supreme Court decisions, the principle of *stare decisis* and the present composition of the Court, if there is to be a general duty owed to the securities market, Congress must impose it.[89] It is submitted that Congress should take up the gauntlet thrown down by the Court. The Securities Exchange Act was promulgated in 1934, over fifty years ago. Rule 10b-5 was issued to enhance language written in 1934. If Congress is not satisfied with the Court's present trend and interpretations, it should act to change the law.[90] Any amend-

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86. *The Supreme Court, supra* note 83, at 293.

87. *Id.* at 294. The commentator succinctly stated that

> [t]he legislative process is best suited to the task of evaluating the competing arguments over efficiency and balancing them against the goal of integrity. Absent a legislative solution, however, *Dirks* ensures that insider trading cases will continue to be decided on the basis of anachronistic and misplaced notions of fiduciary duty.

Id. Yet this is not the final word on the problem of determining what constitutes a fiduciary duty. Another recent commentator suggests that the *Dirks* rule has supplied an answer or drawn a "bright line" between lawful and unlawful conduct. *See* Note, *Rule 10b-5 and the Fiduciary Doctrine: Dirks v. SEC*, 4 J. L. & COMM. 127, 142 (1984), where the author concludes that since fiduciary law is almost entirely judicially developed, the *Dirks* Court properly supplied an answer to the question of the extent of liability under Rule 10b-5, and suggests that under the *Dirks* rule the SEC and lower courts may adjudicate such problems based on a fiduciary theory. *Id.* at 139-42.

While it is true that the courts do have a guideline, it is not as bright as suggested above. With the limiting rule of *Dirks* in place, the problem raised in Justice Blackmun's dissent concerning harm to shareholders caused by one not in a fiduciary relationship to them remains unsolved. *See supra* notes 46, 75 and accompanying text. Additionally, the hypothetical case suggested in *The Supreme Court, 1982 Term* illustrates a loophole allowing escape from liability even where a profit was made. *See supra* note 83 and accompanying text. *Compare* Note, *Securities*, 14 SETON HALL L. REV. 715 (1984) (concluding that Dirks supplies a "guiding principle" to be followed but suggesting that congressional action is necessary). *See also* Comment, *Dirks, Defining the Scope of Rule 10b-5*, 8 DEL. J. CORP. L. 265 (1983) (concluding that new legislation is needed concerning trading on inside information).

88. *Chiarella*, 445 U.S. at 246 n.1.

89. *Id.* at 233. *See* Heller, *Chiarellla, SEC Rule 14e-3 and Dirks: "Fairness" versus Economic Theory*, 37 BUS. LAW 517, 541-42 and nn.58-59 (1984).

90. It is incumbent on Congress to produce new legislation to address the issues with

ment should not only address intentional conduct, but should address negligent and reckless acts as well.[91] It is time Congress took heed of Justice Blackmun's concerns and extended the duty owed, not to the market as a whole, but to some point beyond a fiduciary relationship. An attempt should be made to eradicate the present "all or nothing" approach with more specific language finding an intermediate standard.

Fifty years ago Congress decided to attempt to prevent those with inside information concerning securities traded on the open market from taking advantage of that information. While the Court is unwilling to extend the reach of the current Act to all who obtain inside information, Congress should be able to impose a standard which meets the policy goal of preventing insider trading while not imposing a duty on the market as a whole. To do so would relieve Justice Blackmun of a heavy burden.

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which the Court has been confronted and seems hesitant to act upon. There is obviously a problem since the conduct the SEC is attempting to regulate under Rule 10b-5 is beyond the scope to which the Court is willing to extend the language. For criticism of the SEC's authority to promulgate new rules to effect changes, see Heller, *supra* note 82. *See also* Block & Barton, *Insider Trading — The Need for Legislation,* 10 SEC. REG. L.J. 350, 367 (1983) (criticizing the fact that SEC proposed legislation does not specifically delineate what constitutes unlawful insider trading).

91. For lower court decisions concerning reckless conduct, see Nelson v. Serwold, 576 F.2d 1332 (9th Cir.), *cert. denied,* 439 U.S. 970 (1978) (holding that Congress intended section 10(b) to reach reckless conduct); Keirnan v. Homeland, Inc., 611 F.2d 785 (9th Cir. 1980) (holding that reckless disregard for the truth is actionable under section 10(b) and Rule 10b-5 but recognizing that *Hochfelder* stated that the issue is still undecided). *See Hochfelder,* 425 U.S. at 193-94 n.12.