EFCA stock." *Id.* at 80,845. Petitioner argues (Reply Br. 5 n.2) that he did not disclose the fraud to Fidelity Management and Research "because they expressed no interest in the company and could not be expected to follow up on the allegations." He testified during the Commission's investigation, however, that Fidelity "didn't own stock so I really didn't give [it] the story" (R. 1151).

CONCLUSION

The petition for a writ of certiorari should be denied.*

Respectfully submitted.

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NOVEMBER 1982

*The Solicitor General authorizes the filing of this brief.

No. 82-276

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

RAYMOND L. DIRKS,
Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The District Of Columbia Circuit

BRIEF FOR PETITIONER RAYMOND L. DIRKS

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QUESTIONS PRESENTED

Did the Court of Appeals err in holding liable under the antifraud provisions of the securities laws an analyst—who repeated allegations of corporate fraud made by several former and one present company employees, but denied by management, to many persons, some of whom later sold stock on the open market without disclosing the allegations—on the theory that:

(1) Under *Chiarella* v. *United States*, 445 U.S. 222 (1980), unverified allegations of fraud made by insiders necessarily carry with them a duty not to repeat the allegations to persons who may sell on the open market even if the analyst himself neither has any preexisting fiduciary duty nor obtains the allegations through any breach of an insider's fiduciary duty?

(2) Employees of a registered broker-dealer are "required to meet a high standard of ethical behavior" and therefore automatically have "a duty to the [Securities and Exchange] Commission and the [general] public" that satisfies the fiduciary duty requirement of *Chiarella* v. *United States, supra?*

(3) Unverified allegations of fraud vigorously denied by management are nonetheless "material facts" under the securities laws and *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976)?

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OPINIONS BELOW

The March 29, 1982 judgment of the Court of Appeals is not reported; it is reprinted in the Appendix to the Petition for a Writ of Certiorari at page C-1. The May 18, 1982 opinion of the Court of Appeals is reported at 681 F.2d 824 and is reprinted in the Appendix to the Petition for a Writ of Certiorari beginning at page A-1. The opinion of the Securities and Exchange Commission is reported at 21 S.E.C. Docket 1401, and is reprinted in the Appendix to the Petition for a Writ of Certiorari beginning at page B-1. The Initial Decision of Administrative Law Judge David Markun is reported unofficially in *In re Boston Company Institutional Investors, Inc., et al.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,705, and is reprinted in the Joint Appendix beginning at page 173.

JURISDICTION

The judgment of a divided panel of the Court of Appeals (Judge Tamm, dissenting) was entered on March 29, 1982. On May 18, 1982 Judge Wright filed an opinion in support of the judgment. Judge Robb concurred in the result only. Judge Tamm dissented. A timely Petition for Rehearing and Suggestion for Rehearing *En Banc*, filed on April 27, 1982, was denied on May 19, 1982. A timely petition for a writ of certiorari was filed on August 17, 1982 and was granted on November 15, 1982. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS

This case involves Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a); Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b); and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5. The provisions of these statutes and the regulation are set forth in the Appendix to the Petition for a Writ of Certiorari beginning at page D-1.

STATEMENT OF THE CASE

I. The Proceedings Below

Petitioner Raymond L. Dirks is a professional investment analyst. It is undisputed that in March 1973 Petitioner Dirks, following up unverified allegations of a former employee, uncovered and helped disclose to the public a massive fraud involving, among other things, the creation of fictitious insurance policies at Equity Funding Corporation of America ("Equity Funding" or "EFCA"), which was a major insurance holding company. As a result, twenty-two participants in the fraud were convicted of federal crimes and received sentences ranging up to eight years in jail, along with substantial fines. (*See* Division Ex. 80B, J.A. 149-53, R. 6594, 6595).[1]

[1] The following abbreviations are used: R. = Record; I.D. = Initial Decision; Ex. = Exhibit during SEC administrative proceedings; J.A. = Joint Appendix; Pet. App. = Appendix to Petition for Writ of Certiorari.

It is also undisputed that a somnolent SEC had failed to uncover the fraud despite being given essentially the same leads as Dirks on several different occasions (once by a former member of its own staff) over a period of years.

Dirks, however, who was at the time employed as a securities analyst for the Wall Street firm of Delafield Childs, Inc., investigated these allegations himself and also attempted to have them investigated and publicized by *The Wall Street Journal*. In the course of his investigation, Dirks told many members of the investment community about the allegations of fraud. While most of these people discounted the unconfirmed allegations and some even bought Equity Funding stock after hearing them, others sold stock on the open market without disclosing the allegations. Neither Dirks nor his firm owned or traded any Equity Funding stock. (Dirks Ex. D, J.A. 154, R. 1806, 1956)

The SEC's response to these events was to charge Dirks with having violated and aided and abetted violations of Section 10(b), Rule 10b-5, and Section 17(a) of the securities laws when he repeated the allegations of fraud to members of the investment community who later sold their Equity Funding stock. Five sellers of Equity Funding securities were also named as respondents in the SEC administrative proceedings: The Boston Company Institutional Investors, Inc., The Dreyfus Corporation, John W. Bristol & Co., Tomlin, Zimmerman and Parmalee, Inc., and Manning and Napier.

Administrative Law Judge David Markun, in an Initial Decision rendered on September 1, 1978, found violations of the securities laws as alleged by the Division of Enforcement. He censured four of the trading respondents, imposed no sanction on the fifth, and recommended that Dirks be suspended from associating with a broker or dealer for a period of 60 days.

Dirks filed a timely petition for review of the Initial Decision with the Commission.[2] In response to Dirks' filing his petition

[2] None of the trading respondents sought review of the ALJ's decision.

for review, the Division of Enforcement filed its own petition seeking to increase the sanctions imposed on Dirks.

The Commission rendered its Opinion on January 22, 1981. The Commission found that Dirks had aided and abetted violations of Section 17(a) and Rule 10b-5, but rejected the claim that Dirks had directly violated Rule 10b-5. The Commission also rejected the Division's request for increased sanctions. Recognizing that Dirks played "an important role in bringing EFCA's massive fraud to light," that Dirks "reported the fraud allegations to EFCA's auditors and sought to have the information published in *The Wall Street Journal*," and that in twenty years as an analyst Dirks had an "unblemished" record, the Commission reduced the sanction imposed by the Administrative Law Judge to a censure. (Pet. App. B-26)

On Petition for Review of the SEC's decision, a split panel of the Court of Appeals for the District of Columbia Circuit (Judge Tamm dissenting) issued a three-paragraph judgment on March 29, 1982, denying the Petition. The holding of this judgment was that:

> "The record in this case fully supports the Commission's findings that petitioner breached his duty to the Commission and to the public not to misuse insider information and that he was compensated for so doing. The record also assures us that the other findings of the Commission are not clearly erroneous and that the Commission's conclusions are solidly based in law." (Pet. App. C-1)

The court issued its judgment pursuant to local rule 13(c), which permits the court to render decisions without opinion where "the issues occasion no need therefor." A Petition for Rehearing and Suggestion for Rehearing *En Banc* was filed by petitioner on April 27, 1982, in which it was suggested that at the very least this was a case in which the novel issues raised warranted an opinion. The Petition for Rehearing was denied on May 19, 1982. (Pet. App. C-3 to C-5) On the previous day, however, May 18, 1982, the court issued a 41-page opinion by Judge Wright in support of the judgment. Judge Robb concurred in the result only. Judge Tamm dissented.

Judge Wright noted in his opinion that this case involves "both sensational facts and difficult issues of law and policy." (Pet. App. A-2) Judge Wright observed that investment analysts can play an important independent role in ferreting out corporate fraud and conceded that "[l]argely thanks to Dirks one of the most infamous frauds in recent memory was uncovered and exposed, while the record shows that the SEC repeatedly missed opportunities to investigate Equity Funding." (Pet. App. A-3) Judge Wright also observed that the threat of liability under the antifraud provisions of the securities laws may impede such investigations in the future. (Pet. App. A-3)

Nevertheless, Judge Wright found that Dirks had breached a legal duty of disclosure that he owed "to the SEC and to the public" solely because he was an investment analyst employed by a broker-dealer, and as a member of the securities industry was therefore "required to meet a high standard of ethical behavior." (Pet. App. A-27 to A-31) Judge Wright found that this duty to disclose was "created by the ethical standard that applies to broker-dealers" and that Dirks, in "failing to report promptly what he knew" to the SEC and the public, breached this duty. (Pet. App. A-29, A-31)

Judge Wright also found that since Dirks had heard the allegations about fraud at Equity Funding from former employees and one present employee of Equity Funding, he was a "tippee" of corporate insiders. Because both federal and relevant state law require the disclosure of fraudulent management activities, both the SEC and Judge Wright conceded that these "insiders," in disclosing the alleged fraud to Dirks, had not breached any fiduciary duty. (Pet. App. A-23 to A-25) Moreover, it was undisputed that Dirks himself was a stranger with no preexisting fiduciary duty to those who sold or bought Equity Funding stock. Nevertheless, Judge Wright found that Dirks had automatically acquired a fiduciary duty to "disclose or refrain" from trading on information acquired from the corporate "insiders" and that he breached that duty when he repeated the allegations to others, some of whom later sold Equity Funding stock.

Finally, Judge Wright found that the information in Dirks' possession constituted "material facts" for purposes of the securities laws, even though that information consisted of unverified allegations that did not come "from a source whose word would not be doubted," and were vigorously denied by management. (Pet. App. A-34 to A-35)

II. Summary Of Facts

The underlying facts in this case are largely undisputed. From the middle 1960s through the early 1970s, Equity Funding was regarded by the Wall Street investment community as a highly attractive "growth" company. In November 1971, the Los Angeles regional office of the Securities and Exchange Commission was told by a former Commission staff member that Equity Funding's controller was making allegations of fraud at the company, specifically that Equity Funding was overstating the amount of insurance in force by placing phony policies on its books. The SEC conducted an investigation, rejected an offer by the then former controller to provide information about substantial fraud at Equity Funding in exchange for immunity, found no incriminating evidence and closed its investigation. (J.A. 100-14)

On the morning of March 7, 1973, Ronald Secrist, a former employee of two of Equity Funding's life insurance subsidiaries, met with the New York Insurance Department and made allegations of fraud at Equity Funding in some detail, primarily to the effect that Equity Funding had phony policies on its books and that these policies were being sold to reinsurers as though they were real. (I.D. 138, J.A. 272; R. 376-81; J.A. 23) These allegations were relayed to the California Department of Insurance,[3] which in turn passed them on to the SEC on March 9, 1973. The SEC Los Angeles regional staff

[3] The New York Insurance Department took no other action except for sending a memorandum to the SEC on March 21 and to the New Jersey Insurance Department (which had jurisdiction over one of Equity Funding's subsidiaries) on March 20.

reported that they had previously heard similar allegations by disgruntled employees which did not prove out and recommended that any inspection of Equity Funding operations be delayed until the next year when more personnel would be available. The SEC took no action on the allegations. (J.A. 91-98; Boston Company III Exhibit HHH, J.A. 171-72, R. 7702, 7717) A number of state insurance departments did subsequently commence an intensive audit, but during the relevant time period found no evidence of wrongdoing.

However, also on March 7, 1973, Secrist conveyed the same allegations to Petitioner Dirks, who was a highly respected securities analyst specializing in the insurance industry, and who had a reputation for conducting aggressive and independent investigations of the companies he reported on. (Pet. App. B-3) Secrist told Dirks that he had recently left an Equity Funding subsidiary, Bankers National Life Insurance Co., in protest over the way it was operated, and that there was substantial financial manipulation occurring at Bankers Life. (J.A. 31) (In fact, it subsequently turned out that there was no substantial wrongdoing at Bankers Life and that Secrist had not resigned in protest but had been fired.)

With respect to another Equity Funding subsidiary, Equity Funding Life Insurance Company of America ("EFLIC"), where Secrist had been employed several years earlier, Secrist made essentially the following allegations:

—in 1970, EFLIC had embarked on a program of selling totally fictitious life insurance policies to reinsurance companies, and one-third of EFLIC's insurance in force was fake (I.D. 75-76, J.A. 226-27; R. 219-24, 503-07);

—fictitious death certificates were created in order to collect proceeds of these policies from reinsurers (R. 232-33, 480-81; J.A. 31-32; R. 507, 532-33, 554, 1801);

—in order to reflect the receipt of premiums, EFLIC had printed its own bank statements, showing false deposits, and counterfeited certificates of deposit (I.D. 77, J.A. 227-28; R. 230);

—Equity Funding's real assets amounted to $10,000,000 rather than the reported $250,000,000 to $500,000,000 (R. 537);

—Equity Funding was selling limited partnerships in phony apartment houses (R. 245-46);

—leading Equity Funding officials had sold much of their Equity Funding stock in the previous six months and each had cash and a passport, ready to flee the country at a moment's notice (I.D. 78, J.A. 228; R. 541-42);

—Equity Funding had connections with the Mafia and would obtain contracts on people's lives if they caused trouble (I.D. 77, J.A. 228; R. 493);

—Haskins & Sells, EFLIC's former auditors, had become suspicious of EFLIC and had dropped the account (I.D. 77, J.A. 228; R. 510-11).

It ultimately turned out, although Dirks did not know it at the time, that the first three allegations were essentially correct and the remainder false.

These allegations were, on their face, improbable because the scheme alleged by Secrist would have required Equity Funding to carry out a massive fraud under the noses of three major accounting firms it had used as auditors, the SEC, the New York Stock Exchange, three or four state insurance commissions that regulated Equity Funding's operations, and various prestigious brokerage firms and banks.

Dirks nonetheless decided to investigate the allegations. Dirks understood that Secrist was highly reluctant to approach the SEC or other regulatory agencies since other Equity Funding employees had in the past gone to the agencies with this story, with no result other than word getting back to Equity Funding about the employees' actions.[4] (J.A. 22-23,

[4] Dirks did not know until March 19 that Secrist had gone to the New York State Insurance Department. (I.D. 84, J.A. 232; J.A. 50-51)

36-37, 66-67) Accordingly, Dirks and Secrist agreed not to approach the SEC at that time.[5] (J.A. 66-67)

Dirks instead asked for and received Secrist's permission to talk to *The Wall Street Journal*. (J.A. 21-22, 37-38) On March 12, Dirks telephoned Herb Lawson, San Francisco bureau chief of the *Journal*, whom Dirks knew, did not reach him, and left a message. (J.A. 47-48) As described below, Dirks was eventually put in touch with the *Journal's* Los Angeles bureau chief, William Blundell, with whom, as Judge Wright found, "he was also in touch regularly," and whom he "kept . . . up to date on the progress of the investigation and badgered . . . to write a story for *The Wall Street Journal* on the allegations of fraud at Equity Funding." (Pet. App. A-9)

On March 12 Dirks also called Stanley Goldblum, president of Equity Funding, who invited him to visit Equity Funding's offices in Los Angeles two weeks later. Dirks in fact decided on the evening of March 19 to visit Los Angeles immediately, in order to see if he could confirm or refute Secrist's allegations as quickly as possible.

On March 21, Dirks spent the day at Equity Funding with Goldblum and Fred Levin, Equity Funding's Executive Vice President, as well as with other employees. Dirks was told that insurance examiners from three states had found nothing wrong at the company (R. 807-10, 812-15, 1280-87, 1289-90, 8565), and was also shown details of the company's reinsurance arrangements and sales policies that contradicted Secrist's

[5] Dirks was also reluctant to approach the SEC because of his own prior experience with the SEC staff. Dirks had previously gone to the SEC with information of insider trading at ITT. Although the staff promised to keep Dirks' name, and those of his sources—some of whom were clients—confidential, the staff told Dirks' clients of his meeting with the SEC and of the fact that he had named them as sources. As a result, Dirks lost business, lost standing in the Wall Street community, and was unenthusiastic about the behavior of the Commission's staff. (J.A. 66-67; Boston Company III Ex. JJJ, p. 90, R. 8264, 8390)

allegations. At the end of his visit, Dirks told Levin he did not believe the allegations and thought Secrist was a disgruntled ex-employee. (R. 977-80, 1287, 1292-97, 1301-09, 1328-32, 1879-80, 8472, 8474)

During this same time period Dirks also met with various former and current Equity Funding employees whom Secrist said could corroborate his story. The two principal sources were Patrick Hopper, a former Equity Funding vice president, and Frank Majerus, another former employee. Hopper told Dirks that Secrist had been fired and that there was no Mafia connection at Equity Funding. Hopper also said that he had heard these allegations from Secrist before, and that Secrist had a tendency to exaggerate and imagine things. Hopper nonetheless said that he tended to believe some of the allegations, although he had no proof of them, had never spoken to anyone who had direct knowledge of them, and did not believe Secrist had any real evidence. (R. 785-89, 874-76, 1270-73) Majerus told Dirks that he had been involved in activities in 1970 that he believed related to inflating insurance in force figures, but that he had no knowledge of the company's current practices. (R. 1276-77, 1607)

Dirks' other sources likewise provided no firm corroboration of Secrist's story. One of them, Gene Thibideau, said he thought there was phony insurance as a "one shot deal" which was "gone and buried" in 1970. (R. 994-96, 999-1002, 1352-53) Two others, Peter Ronchetti and Brian Tickler, thought that Equity Funding had been putting phony insurance policies on its books in 1971 but had no knowledge of Equity Funding's practices thereafter. (R. 1002-03, 1004-06, 1012-13, 1025, 1088-91, 1092-96, 1101-02, 1106, 1359-61) Donald Goff, the one current employee with whom Dirks spoke, said that his knowledge was not current, but he believed that Equity Funding had in the past inflated its insurance in force figures. (R. 1012-13, 1028-31, 1039; Division Ex. 4, R. 315, 317)

Dirks had reached Herb Lawson of the *Journal* on March 19, and had related to him Secrist's allegations. Lawson told Dirks that he was too busy to look into the situation because he had to

attend an annual (*i.e.*, routine) meeting of the Bank of America, but that he might refer the matter to the *Journal's* Los Angeles office. (J.A. 48-50)

On March 21, Dirks arranged to meet with William Blundell, Los Angeles bureau chief of the *Journal*. Dirks related to Blundell the Secrist allegations in detail and gave Blundell the names of additional people with whom he had talked or whom Secrist had said knew something about the fraud. (J.A. 52-54, 119-22) Blundell thought the allegations were "laughable" or at least "terribly unlikely," and told Dirks he could not write a story based on them because they were "flat out rumors." (J.A. 54, 122-26, 127-28, 136-37) Blundell did not think the rumors were of sufficient weight to bring to the attention of the SEC. (J.A. 128-29) Blundell began his own investigation on March 21. Blundell conducted a ten day investigation (J.A. 130), during which he talked to Secrist, additional sources given him by Dirks, and others. (J.A. 16-17, 61-62, 131)

Between March 23 and 26 Dirks called Blundell several times to inquire if he had enough information yet to publish a story. Even though Blundell had talked to numerous sources given him by Dirks and Secrist, he told Dirks throughout this period that he did not have sufficient information to justify publishing a story. (J.A. 55-56, 59-62, 131, 136-37) In fact, Blundell testified that he did not feel he could publish a story until the evening of March 30 (J.A. 130), which was after the first hard evidence of fraud at Equity Funding had been uncovered and well after trading in the company's securities was suspended. The *Journal* did not publish a story until April 2.

Dirks also sought to have Equity Funding's present and former auditors look into these allegations. On March 24 Dirks met with the partner in charge of the Equity Funding account at Seidman & Seidman, its then current auditors. Dirks related Secrist's allegations and gave the partner a copy of his notes from his meeting with Secrist. The partner turned the notes over to Equity Funding and took no other action. (J.A. 45, 56-57, 57-58; R. 7879-81) That same day Dirks met with the Haskins & Sells partner in charge of the EFLIC account until

1971. This partner said he had never heard any allegations of impropriety at the company and did not understand how it could have possibly occurred during his tenure as auditor. (J.A. 43-44, 56-59) Neither auditor notified any regulatory agency of the allegations.

Dirks did not himself (nor did his company) trade in any capacity in Equity Funding stock. In the course of his investigation Dirks did, however, speak with certain members of the investment community in an attempt to determine if the Secrist allegations could have any substance. Furthermore, as Dirks' investigation proceeded, he took calls from various persons within the community who were seeking to find out what he knew about Equity Funding. Dirks spoke with anyone who sought to contact him and conveyed the substance of what he had heard, including any information which tended to undercut the allegations. As Judge Wright found, "[o]n all occasions Dirks candidly discussed the status of his investigation with anyone who asked." (Pet. App. A-7)

While some of the people Dirks spoke to about the allegations sold their Equity Funding stock, they did not necessarily believe the allegations Dirks related to them, but did believe that the circulation of these rumors would depress the price of Equity Funding stock.[6] Even more importantly, these people represented only a small portion of the investment professionals who heard the allegations about Equity Funding. The record discloses that numerous other individuals and firms heard the allegations, from Dirks or otherwise (*see, e.g.*, J.A. 64-66), and either held their Equity Funding stock, recommended that others hold or buy the stock, or in fact purchased large amounts

[6] For example, while Boston Company Institutional Investors, Inc. ("III"), one of the trading respondents below, eventually decided to sell its Equity Funding stock, Gerry Zukowski of III told Dirks on March 21 that this was because of the stock's declining market position, and even though he did not believe Secrist's allegations. (R. 803-06, 817, 821, 1457-58)

of additional stock, believing the price to be artificially low due to unfounded rumors. (*See, e.g.*, R. 1392-94, 1402-03, 1794-96, 1801, 8486-88, 8563-64; Division Exs. 42, R. 3378, 3406, and 43, R. 3379, 3422)

During this time, the various regulatory agencies charged with investigating and reporting corporate wrongdoing, including the SEC, heard the various allegations but either failed to act or, if they acted, failed to verify the allegations. As noted, the SEC, which had first heard the allegations in 1971, was again informed of the allegations on March 9, 1973, by the California Insurance Department,[7] but failed to take any action. On March 23, Blundell of *The Wall Street Journal*, who had by then been investigating independently for two days, informed Stanley Sporkin and Ralph Erickson of the SEC's Division of Enforcement in detail about the allegations. (J.A. 63, 132-33; Dirks Ex. R, J.A. 163-64, R. 7949, 7950) The SEC neither called Dirks (J.A. 63), nor took any other immediate action. As Sporkin later explained to a Congressional committee, even after hearing the detailed story the SEC considered the story to be an unverified rumor on which it could not act. (Boston Company III Ex. JJJ, p. 90, R. 8264, 8390)

On the evening of March 26, at Blundell's suggestion, Dirks called the head of the SEC's Los Angeles Regional Office at home and, accompanied by two former Equity Funding employees, went to the Regional Office the next day. Dirks testified for four days, telling the SEC everything he had heard about allegations of fraud at Equity Funding. (J.A. 61-62; Dirks Ex. R, J.A. 163, 164-65, R. 7949, 7950)

On March 27 the New York Stock Exchange, reacting to circulating rumors of fraud at Equity Funding, and a resultant

[7] The California Insurance Department also notified the Illinois Insurance Department, which on March 13 sent two examiners to conduct its periodic examination of EFLIC. This examination, however, failed to verify the allegations until well after trading in Equity Funding's stock had been suspended.

complaint of "disorderliness" in the market (*see* Pet. App. A-10), halted trading in the company's securities. The SEC also suspended trading in the securities on March 28, even though at that point, after Dirks had been testifying for two days, the SEC official investigating the matter was not convinced the allegations were true.[8] (R. 8631, 8639) Likewise, an Exchange official investigating the matter, after reviewing the transcripts of Dirks' SEC testimony, concluded that the story "was not fact" supported by any hard evidence. (R. 9119-20; Bristol Ex. H, R. 8784, 8796) Indeed, the ALJ found that both the Exchange and the SEC acted "without awaiting proof of the allegations 'as a fact.' " (I.D. 132-35, J.A. 268-70)

The first hard evidence supporting the allegations did not come until March 30, when the Illinois Insurance Department discovered that substantial cash assets of Equity Funding, which were supposed to be in a Chicago bank, were missing, discovered other evidence of asset manipulation, and found that officers of Equity Funding had refused to sign affidavits swearing that there was no fraud. (I.D. 132-35, J.A. 268-70; R. 7059-69, 7070-73, 7206-07, 7418-19; Boston Co. III Exs. Z, R. 7215, 7219, 7673, YY, R. 7410, 7410, and ZZ, R. 7412, 7412; Bristol Ex. F, R. 6977, 6979) It was only at that point that the California Insurance Department stepped in and used its emergency powers to seize EFLIC. (R. 7209; Boston Co. III Exs. Z, R. 7215, 7219, 7673, and BBB, R. 7421, 7422) And it was only at that point that Blundell concluded that he could write a story reporting the allegations for the *Journal*. (J.A. 130)

Equity Funding filed a Chapter X petition on April 5, 1973. In 1975 the bankruptcy trustee issued a report detailing the results of his investigation into the company's activities. The report confirmed some of Secrist's allegations, but also determined that many of them were false.

[8] As Stanley Sporkin testified before Congress, trading was suspended because the SEC believed that either the allegations were true *or* there was a bear raid on the stock, but did not know which was the case. (Boston Company III Ex. JJJ, p. 90, R. 8264, 8390)

As a result of Dirks' efforts, a criminal fraud which had been ongoing since the mid-1960's, and which the regulators had failed to catch, in spite of being given repeated leads, was finally exposed. Following a seven-month investigation by the SEC, the FBI, the United States Attorney's Office in Los Angeles, and other agencies, a federal grand jury on November 1, 1973 returned a 105-count indictment against twenty-two participants in the fraud. All twenty-two were convicted and received sentences ranging up to eight years in prison, as well as substantial fines. (Division Ex. 80B, J.A. 149-53, R. 6594, 6595)

SUMMARY OF ARGUMENT

The court below held that petitioner Dirks aided and abetted violations of the antifraud provisions of the securities laws when he circulated allegations of an ongoing fraud at Equity Funding to persons in the investment community, some of whom later sold Equity Funding securities on the open market, even though it was agreed that Dirks was himself not an Equity Funding insider, was legitimately told of the allegations by former employees of the company, did not misappropriate the information, and even though both Dirks and his sources were under no fiduciary duty not to repeat these allegations to others. That holding is inconsistent with this Court's decision in *Chiarella* v. *United States*, 445 U.S. 222 (1980).

In *Chiarella*, this Court held that under the antifraud provisions of the securities laws a duty to disclose non-public information arises only out of a relationship between the person possessing the information and those purchasing or selling the securities. This Court held that such a duty does not arise as a result of the mere possession of such information. Even the dissenting Justices in *Chiarella* agreed that mere possession of such information may give rise to a duty of disclosure only where it is illegally obtained, *id.* at 239-43 (Burger, C.J., dissenting), or where it is not legally available to others in the investment community, *id.* at 245-52. (Blackmun, J., dissenting.)

Neither Dirks nor his company ever traded in Equity Funding securities. He was a stranger to, and had no relation of trust with, any purchaser of Equity Funding securities. The court below, and the Commission before it, nonetheless held that Dirks acquired a duty to "disclose-or-refrain" simply because he legally and properly obtained information about Equity Funding which the court held to be material and nonpublic.

The court first held that Dirks acquired such a duty because he was automatically a "tippee" of corporate insiders, and inherited whatever duties those insiders had to Equity Funding and its shareholders. This is incorrect. "Tippee" liability exists only where the recipient of the information improperly acquires it through a breach of a corporate insider's duty to the company, and thereby himself acquires duties as a participant in the breach. *See, e.g., Chiarella, supra*, 445 U.S. at 230 n.12; *In re Investors Management Co.*, 44 S.E.C. 633, 648-51 (1973) (concurring opinion). The SEC conceded, however, that Dirks' sources breached no duty in talking to him. Nor did Dirks misappropriate or illegally obtain the information from the company. He acquired the information from sources who were legally free to give it to him. (Pet. App. A-23) This information was, indeed, legally available to anyone willing to undertake the effort that Dirks did. Dirks' sources were willing and eager to discuss the allegations. Under such circumstances, Dirks did not acquire any duty.

Indeed, rather than violating a duty to Equity Funding or its shareholders, or to the market in general, Dirks' activities brought to light a massive fraud at Equity Funding and informed the market of the true state of affairs at the company. But for Dirks' efforts, the fraud might well have gone undetected altogether.

By misapplying controlling precedent, the court below reached a result that is entirely contrary to public law enforce-

ment policy and that will have a substantial negative impact throughout the securities industry. It is hard to imagine how, given his position as an outsider and the SEC's repeated failure to successfully investigate the fraud allegations, Dirks could have gone about publicizing them other than the way he did—by talking to the press and to anyone else who would listen to him. The SEC's suggestion of a duty to disclose and its "disclose or refrain" rhetoric may make sense where those in possession of the information, such as corporations or managers of corporations, are in a position to make disclosure on behalf of the company. But applying the "disclose or refrain" rhetoric to an outsider like Dirks who is investigating allegations of management fraud which will never be voluntarily disclosed by the management and who cannot persuade the press to publish a story will result only in discouraging independent investigation of such allegations. A more counterproductive result can hardly be imagined.

The court below also held that Dirks, because he was an employee of a registered broker-dealer, had a special duty of disclosure to the public and to the SEC. This holding was based solely on the theory that all securities professionals are supposed to maintain a high degree of ethics, and that such ethical duties can be translated into a fiduciary duty. This novel theory is entirely without foundation in the law, is inconsistent with *Chiarella*, and should not be allowed to stand.

Finally, the court erred in holding that the unverified allegations of fraud heard by Dirks were "material facts." Unsubstantiated and incredible rumors, which were vigorously denied by management and many of which proved ultimately to be wrong, are not "facts." *E.g., SEC* v. *Monarch Fund*, 608 F.2d 938, 942 (2d Cir. 1979); *Hassig* v. *Pearson*, 565 F.2d 644 (10th Cir. 1977). The record shows that while some of those who heard the rumors sold their Equity Funding securities, many more either did nothing or actually purchased, or recommended purchasing, the stock. The SEC itself did nothing after hearing these allegations from a former Division of Enforcement attorney in November 1971. It continued to do nothing after hearing them from the California Insurance Department on March 9, 1973, from a reporter for *The Wall Street Journal* on March 23, 1973, and from Dirks himself on March 27, 1973. When asked by a Congressional committee why the Commission and its staff had failed to act as late as March 27, Stanley Sporkin of the SEC responded that they had nothing but unverified rumors, upon which they could not responsibly act. No other court has ever held such uncertain and untrustworthy allegations to constitute "facts" under the antifraud provisions of the securities laws.

ARGUMENT

I. Dirks Was Under No Duty Within The Meaning of *Chiarella* v. *United States* With Respect to Allegations of Ongoing Criminal Fraud at Equity Funding

A. Dirks Did Not Acquire a Fiduciary Duty Where He Legitimately Acquired Information of Criminal Fraud from Equity Funding Employees, and Where the Employees Breached No Duty in Providing the Information to Him

In *Chiarella* v. *United States*, 445 U.S. 222 (1980), this Court held that "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak." *Id.* at 234-35. Furthermore, "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.' " *Id.* at 228, *quoting Restatement (Second) of Torts* § 551(2)(a) (1976).[9]

[9] Because Rule 10b-5 is modeled after Section 17(a) to prohibit similar conduct, *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 212-13 n.32 (1976), these principles are equally applicable to the charges under that statute.

Contrary to the decisions below, Dirks had no such duty. Dirks acquired the information legitimately in the course of an investigation which led to the uncovering of a long-concealed fraud at Equity Funding. Dirks' sources did not breach any duty in providing the information to Dirks. Dirks was a stranger to, and did not himself have a fiduciary, or other relationship of trust and confidence with any purchaser of Equity Funding securities. Dirks was not an Equity Funding officer, director, or employee. He did not purchase or sell Equity Funding stock and was not involved as an agent or broker in any sale. There was, accordingly, no breach of any fiduciary or other duty by Dirks.

1. Dirks Was Not a "Tippee" Where He Acquired Information from Sources Who Breached No Duty in Giving Him the Information

The Commission and the Court of Appeals found that Dirks acquired a duty to disclose because, they held, he received material, nonpublic information from corporate insiders of Equity Funding, and thereby became a "tippee" of the insiders, subject to the same disclosure obligations that insiders have. (Pet. App. A-25; B-21) The finding that Dirks was a "tippee" of corporate insiders was incorrect.

As this Court recognized in *Chiarella,* while "tippees" may acquire fiduciary duties, this is not because they received inside information, but rather because they received the information *improperly:*

> "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. *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 237-38 (CA2 1974). The tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty. Subcommittees of American Bar Association Section of Corporation, Banking, and Business Law, Comment Letter on Material, Non-Public Information (Oct. 13, 1973),

reprinted in BNA, Securities Regulation & Law Report No. 233, pp. D-1, D-2 (Jan. 2, 1974).

445 U.S. at 230 n.12.

"Tippee" liability has been imposed only in circumstances where the "tippee" has known, or has had reason to know, that he had improperly obtained inside corporate information. For example, in *In re Investors Management Co.*, 44 S.E.C. 633 (1971), the Commission stated that in finding "tippee" liability, "the appropriate test . . . is whether the recipient knew or had reason to know that the information was non-public and had been obtained *improperly* by selective revelation or otherwise." *Id.* at 643 (emphasis added). Commissioner Smith, concurring in *Investors Management*, expressly read this test to mean that before a "tippee" can be held liable it must be shown that he received information in breach of an insider's duty not to disclose it. *Id.* at 648-51.

The theory underlying "tippee" liability has been that confidential "inside" corporate information is an asset of the corporation and its shareholders. As such, it may only be used for legitimate corporate purposes and may not be appropriated by corporate insiders, who owe duties of trust and loyalty to the corporation, for their own use.

Disclosure of confidential corporate information for anything other than a legitimate business purpose, accordingly, constitutes a breach of trust. As Professor Brudney has observed, the insider is in effect selectively selling corporate information in a situation where he is forbidden to divulge it to the public. Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 Harv. L. Rev. 322, 348 (1979). Where an outsider who receives such information knows, or should know, that he has received confidential corporate information in breach of trust, it is a simple matter to hold him liable for any further use of the information.

As the ABA Comment Letter cited in footnote 12 of *Chiarella* stated:

> [It] appears that the Commission's view is based upon the premise that the tippee who does trade upon such information is a participant after the fact in the tipping corporate official's breach of fiduciary duty, and, under common law principles, the tippee may be held responsible for the consequences of that breach in appropriate cases.

ABA Comment Letter, *supra*, BNA Securities Regulation & Law Report (No. 233), at D-2 (citation omitted).

Indeed, this was the view of Professor Loss, who first coined the term "tippee": a "tippee" should only be liable under Rule 10b-5 where he "knew, or at least should reasonably have inferred, that an insider's tip was a 'breach of trust.'" 3 L. Loss, *Securities Regulation* 1451 (1961). Professor Loss traced "tippee" liability to the concept in the law of restitution that " '[w]here a fiduciary in violation of his duty to the beneficiary communicates confidential information to a third person, the third person, if he had notice of the violation of duty, holds upon a constructive trust for the beneficiary any profit which he makes through the use of such information.' " *Id., quoting Restatement of Restitution* § 201(2) (1937).

Other authorities have likewise expressed the view that "tippee" liability exists only where there has been a breach of trust by an insider. *See Ross* v. *Licht*, 263 F. Supp. 395, 410 (S.D.N.Y. 1973); *Brudney, supra*, 93 Harv. L. Rev. at 348; Fleischer, Mundheim & Murphy, *An Initial Inquiry Into the Responsibility to Disclose Market Information*, 121 U. Pa. L. Rev. 798, 818 n.76 (1973); *cf.* 3 A. Bromberg & L. Lowenfels, *Securities Fraud & Commodities Fraud* § 7.5(3)(d), at 190.10 (transmission of information for legitimate corporate purpose is not "tipping"); 5A A. Jacobs, *Litigation and Practice Under Rule 10b-5* § 92, at 4-28 (same).[10]

[10] The Commission itself has never taken the position that "tippee" liability may be imposed where there has been no breach of fiduciary duty by the insider. All that it has said is that the recipient of the information need not have "actual knowledge that the information was disclosed in a breach of fiduciary duty not to reveal it." *In re*

The imposition of "tippee" liability under such circumstances is thus nothing more than an application of the well-accepted common law principle that one who acquires confidential corporate information through participation in misappropriation may become a "constructive trustee" of the corporation with fiduciary duties with respect to that information. *See* 5 A. Scott, *Scott on Trusts* § 506, at 3569-70 (1967).

In the present case, however, Dirks' sources did not breach any duty to Equity Funding by revealing to Dirks information about an ongoing criminal fraud at the company. Indeed, both the Commission and the court below conceded that Dirks' sources were under no obligation to keep evidence of a crime confidential. (*See* Pet. App. A-23; B-21 n.42; SEC Court of Appeals Brief at 50)

Dirks' sources were not disclosing corporate "inside" information. "Inside" information is "confidential information intended to be available only for a corporate purpose and not for the personal benefit of anyone." *Feldman* v. *Simkins Industries, Inc.*, 679 F.2d 1299, 1304 (9th Cir. 1982); *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961). The information was neither a legitimately confidential corporate asset nor intended for a corporate purpose. As one commentator on this case has observed, "[i]nformation relating to a gigantic corporate fraud upon others can scarcely be considered a corporate asset or as having a valid corporate purpose." Heller, *Chiarella, SEC Rule 14e-3 and Dirks: "Fairness" versus Economic Theory*, 37 Bus. Law 517, 548 (1982).

In sum, Dirks was not a "tippee" as that term has previously been understood because he did not acquire inside information through an insider's breach of duty. As Professor Easterbrook, commenting on this case, has observed, "when the

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Faberge, Inc., 45 S.E.C. 249, 256 (1973); *see In re Investors Management Co., supra*, 44 S.E.C. at 643. These statements indicate that a breach of duty by the insider is required, but that constructive knowledge of the breach will suffice.

release of information was not wrongful—and certainly the former employees of Equity Funding did no wrong in telling Dirks about the fraud—there is no justification for barring the use of the information." Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 S. Ct. Rev. 309, 338.

2. Dirks Did Not Misappropriate or Illegally Obtain Information About Equity Funding

In their opinions in *Chiarella*, Chief Justice Burger and Justice Brennan suggested that a fiduciary duty may arise with respect to nonpublic, material information where the information is obtained by unlawful means. 445 U.S. at 239-43 (Burger, C.J., dissenting); *id.* at 238-39 (Brennan, J., concurring). The Chief Justice stated, and Justice Brennan agreed, *see id.* at 239, that a disclosure obligation should exist "when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means," *id.* at 240.

In this case, Dirks obtained information about an ongoing criminal fraud at Equity Funding in a totally legitimate manner. He was given this information by sources who had a legal right to inform him of this massive crime. (Pet. App. A-23) Indeed, under the law of California, where Equity Funding was headquartered, these employees had a duty to expose fraud or face possible criminal liability. Cal. Corp. Code § 3019 (1955), now renumbered with technical emendations as Cal. Corp. Code § 2254 (1977). (Pet. App. A-23) And, as it turned out, Dirks was first approached by Secrist because Secrist wanted to expose the fraud, knew that prior approaches to regulatory agencies had gotten no results, and valued Dirks' reputation, in Judge Wright's words, as someone who had shown "willingness to go beyond mere financial data in evaluating investments." (Pet. App. A-4)(J.A. 19) Any additional information Dirks obtained from his other sources was the result of "two weeks of concerted effort" (Pet. App. A-3), during which Dirks tracked down and spoke to sources identified by Secrist, evaluated their stories, and also sought out and evaluated information that might rebut or explain away those stories. This information was not only obtained in a totally legal manner, but was in fact obtained as a result of Dirks' "superior experience, foresight, or industry."

3. The Decisions Below that Dirks Acquired Fiduciary Duties Simply by Receiving Material, Nonpublic Information About Equity Funding Are Inconsistent with *Chiarella*

The court below recognized that there was no breach of duty by Dirks' sources and that Dirks himself had breached no preexisting duty to any purchaser of Equity Funding securities, but the court held that such a breach was not required—finding instead that *anyone* who acquires material, nonpublic information from an insider becomes, by virtue of having acquired such information, a fiduciary with respect to the information. (*See* Pet. App. A-24 to A-25, B-20 to B-21 & n.42) This holding is without foundation.[11]

Indeed, the decision of the Court of Appeals is directly contrary to this Court's decision in *Chiarella*. In *Chiarella*, this Court refused to find

> a general duty between all participants in market transactions to forego actions based on material, non-public 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.

[11] Both the court and Commission relied principally on *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974). In *Shapiro*, however, the tipper was an underwriter who had a fiduciary duty to its client company, as the SEC itself found in a related proceeding, and breached that duty in disclosing inside information of that client company to its "tippee" customers. *See In re Investors Management Co., supra*, 44 S.E.C. at 645.

Id. at 233.[12]

Yet the court below has formulated precisely such a broad duty, holding that solely because Dirks legitimately acquired material, nonpublic information about Equity Funding he automatically acquired a fiduciary duty. As one commentator has observed, this holding "amounts to a 'constructive breach' theory, one going well beyond the rationale offered in the *Chiarella* footnote [, and] is clearly a step removed from the 'common enterprise' approach, and a novel application of fiduciary attribution principles." Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 Cal. L. Rev. 1, 30 (1982) (footnote omitted).[13]

[12] The Commission argued in the court below that *Chiarella* should be confined to cases involving "market" information and should not apply to cases involving information stemming from the corporation. Counsel for the Commission contended that the legislative history of the securities laws indicated that market information and "inside" information were intended to be treated differently, and that this was the basis for this Court's decision in *Chiarella*. (SEC Court of Appeals Brief at 55) In fact, this Court drew no such distinction in *Chiarella* and, as Chief Justice Burger noted, "[i]t is clear that § 10(b) and Rule 10b-5 by their terms and by their history make no such distinction." 445 U.S. at 241 n.1 (dissenting opinion), *citing* Brudney, *supra*, 93 Harv. L. Rev. at 329-33.

[13] Professor Langevoort went on to note that while the theory might be based on the concept that one who misappropriates confidential information is deemed a trustee *ex maleficio*, and may be held to account for his use of the information, for such a duty to be imposed "there must be some expectation of trust and confidence with respect to the information imparted, and the person receiving the information must assent at least implicitly to the expectation." *Id.* at 31 n.121. Here there was no expectation by Dirks' sources that he would keep their information in confidence, and there could not legitimately have been any such expectation. In fact, Secrist testified that his intention was to get the information out, drive the price of Equity Funding's stock down, and thereby force the various regulatory agencies to take action. (J.A. 15-16)

The decision below is also sharply at odds with what appears to be the only other post-*Chiarella* decision on this question to date. In *Walton* v. *Morgan Stanley & Co., Inc.*, 623 F.2d 796 (2d Cir. 1980), the Second Circuit Court of Appeals held that an investment banking firm did not acquire or breach any *Chiarella*-type fiduciary duty to a corporation which was not a client when it traded in the corporation's stock on the basis of confidential earnings reports it acquired from the corporation while investigating it for a client. *Id.* at 798-99. The investment banking firm had received the information legitimately, and while the firm knew that the information was confidential corporate data that came from inside the company, and had been expected to keep it so, the company had secured no agreement that the firm would do so. In the absence of any confidentiality agreement, or other fiduciary relationship, the court held, the investment bankers did not acquire any duty with respect to this information simply by receiving it legitimately. *Id.* at 799.[14]

To be sure, under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, or attorney working for the company, such outsiders may, as a result of such relationship, become fiduciaries of the company with an obligation not to use the information except for company purposes. The basis for such an obligation is not simply that such persons acquired nonpublic corporate information, but that they have a "confidential relationship in the conduct of the business of the enterprise,"[15] and are given access to information "solely for corporate purposes." Brudney, *supra*, 93 Harv. L. Rev. at 347-48; *see SEC* v. *Monarch Fund*, 608 F.2d 938, 942 (2d Cir. 1979).[16] But as the court below and the Commission recognized, Dirks had no such confidential relationship with Equity Funding. He was not given this information in order to assist "in the conduct of the business" of Equity Funding but, rather, to expose a massive fraud at the company. As a result, the court below was reduced to finding a general duty applicable to anyone possessing what is found to be material, non-public information, even though this Court has made clear that no such duty exists.

[14] Although the SEC sought, in opposing the Petition for a Writ of Certiorari, to distinguish *Walton* on the ground that it was a state law case, the Second Circuit expressly noted that the type of duty at issue was precisely the type of duty required under *Chiarella*. For this reason, *Walton* has been viewed as being in direct conflict with this case. *See* Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, *supra*, 70 Cal. L. Rev. at 30-32.

[15] Prior to *Chiarella* a few courts appeared to disclaim the need to find a "special relationship" between an outsider and the company, and at least implied that anyone who enjoys "unequal access" to nonpublic material information owes a duty to disclose or refrain from using that information. *See Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, *supra*, 495 F.2d at 236 & n.13; *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). In his dissenting opinion in *Chiarella* Justice Blackmun, joined by Justice Marshall, espoused this "unequal access" test. Although this Court rejected the "unequal access" test, even under Justice Blackmun's approach Dirks was under no duty to disclose-or-refrain. Justice Blackmun stated that he "would hold that persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage." 445 U.S. at 251. In this case the information was legally available to anyone who chose to seek out and talk to Dirks' sources. Dirks' sources were not only legally free to talk to anyone, but were eager and willing to talk. When given the opportunity they talked freely with Blundell of *The Wall Street Journal* (J.A. 17, 61-62), and with other investors (J.A. 39-40). Dirks was not exploiting a "structural informational advantage." If he obtained any informational advantage, it was because of the exercise by him of superior skill and diligence.

[16] The Commission itself has taken a similar approach in finding persons who have legitimately received non-public information liable for trading on that information. For example, in *In re Cady, Roberts & Co.*, *supra*, the Commission said "our task here is to identify those

4. The Decisions Below Elevate Information of Criminal Fraud to the Level of Legitimate "Inside" Information and Will Deter the Detection of Such Fraud

The decisions below not only have no support and are inconsistent with *Chiarella*, but are also contrary to public policy. They have the effect of elevating information about an ongoing criminal fraud to the level of legitimate "inside" information, and granting such information the status of secret "inside" information. As noted, what Dirks' sources disclosed was not "inside" information intended for a confidential corporate purpose, but was evidence of a crime.

The decisions below work to shield perpetrators of corporate crimes by holding information about such crimes to be a confidential corporate asset, and by holding those who acquire such information to be fiduciaries of the corporation with respect to such information. This result is contrary to the public interest. Legitimate "inside" information is properly kept confidential for the benefit of the corporation. To the extent the market has an interest in such information, it will either eventually be revealed or reflected in the corporation's financial statements. But, as Professor Kenneth Scott has observed, there is a critical distinction between the use of "inside" information and the situation presented here. Since inside information eventually will be disclosed by the company,

persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities." 40 S.E.C. at 912. In *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933 (1968), the Commission pointed out that Merrill Lynch had only acquired inside information "by virtue of its business relationship with the issuer." *Id.* at 937. In a subsequent related proceeding, the Commission construed this relationship to be a "corporate insider position that Merrill Lynch in effect occupied by virtue of its role in assisting Douglas in its corporate financing functions." *In re Investors Management Co., supra*, 44 S.E.C. at 645. *See also In re Van Alstyne, Noel & Co.*, 43 S.E.C. 1080, 1085 (1969) (underwriter found liable under Rule 10b-5 on theory that it enjoyed "access by virtue of a special relationship to the issuer to material information").

or accurately reflected in its financial statements, the use of inside information does nothing more than allow the possessors to get a jump on the market, thereby "accomplishing nothing but some wealth transfers. Equity Funding, however, represents an outsider expending efforts to discover fraud, and fraud detection is a socially valuable activity." Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. Leg. Stud. 801, 813 (1980).

Unlike "inside" information, information of corporate crime by senior management will almost never be disclosed voluntarily. The Equity Funding fraud had gone on for years undetected. As a number of observers have noted, it was only Dirks' possession and use of the allegations that informed the market that something might be wrong at Equity Funding and that brought the fraud to light. *See* H. Kripke, *The SEC And Corporate Disclosure: Regulation in Search of a Purpose* 295 (1979); Heller, *Chiarella, SEC Rule 14e-3 and Dirks: "Fairness" versus Economic Theory, supra*, at 549-50; Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information, supra*, at 337. Indeed, Stanley Goldblum, the former president of Equity Funding who was sentenced to eight years in prison for his part in the fraud, was of the view that but for Dirks the Equity Funding fraud could have been successfully buried, perhaps forever (J.A. 116-17), and that Dirks is "entitled to personal credit" for uncovering the fraud. (J.A. 115)

By equating information of criminal fraud with "inside" information, the decisions below assure that such information will be treated secretly by outsiders who become aware of it, and that the fraud will remain hidden. As Professor Kenneth Scott has commented, *supra*, at 818, "the SEC's Equity Funding position is a boon to the successful commission and prolongation of corporate fraud." The securities laws do not command a result so contrary to public policy, and so sure to deter others who, like Dirks, would seek to ferret out and expose corporate fraud.

In particular, the decisions below will greatly inhibit the independent securities analyst, who often is in a position to learn of and investigate allegations of corporate wrongdoing, from conducting such investigations. Rumors and allegations of wrongdoing, often circulated by disgruntled former employees like Secrist, are frequently heard by those in the investment community. (*See* J.A. 78-81, 119, 126; R. 8888, 8928-29) Under the decisions below, an analyst like Dirks who hears of allegations of fraud has two choices. He can make the allegations public, which as the present case demonstrates, is practically impossible for an analyst who has no control over the regulatory process or the media.

Alternatively, he can remain silent. Indeed, in its oral argument to the Commission the SEC staff explicitly argued that it would have been appropriate for Dirks to have done "nothing" with the allegations.

Either way, the public is deprived of the benefits of independent investigations because the analyst has no incentive to investigate. The court below failed to understand this. It recognized that Dirks' activities served the public interest because he uncovered and exposed "one of the most infamous frauds in recent memory" (Pet. App. A-3), and "[b]oth the State and the public at large have an interest in exposing corporate misconduct." (Pet. App. A-25) But it suggested that Dirks should nonetheless be condemned because rather than investigating and exposing the fraud as a free public service, "he was compensated for so doing." (Pet. App. C-2; *id.* A-9, A-38 to A-40)

The comment that Dirks was compensated is substantially wrong as a matter of fact.[17] But more important, it ignores the obvious point that public policy encourages uncovering serious

[17] This comment is a reference to the fact that of the literally dozens of persons and companies to whom Dirks reported the allegations—some of whom bought, some of whom sold, and some of whom did neither—one decided to give the company which employed Dirks some additional commission business. (Pet. App. A-9 n.5)

corporate fraud even if the investigation is not motivated entirely by altruism. As Judge Wright correctly conceded, a reason why an independent financial analyst would undertake an investigation while the regulatory agencies and the press failed to act, was that the analyst (here Dirks) has "more immediate financial and reputational incentives to discover the truth. . . ." (Pet. App. A-26) In undertaking his investigation, Dirks was engaging in the normal business activities of securities analysts. (Pet. App. A-39) If an investigation had not held out the possibility of financial or at least reputational benefit (which, indirectly, might translate into financial benefit), no analyst would be likely to investigate.

The decision below removes such "financial and reputational incentives" by imposing on analysts an obligation, if their research uncovers any evidence of fraud or misconduct, to disclose it publicly (which, as noted, is probably impossible) or face the prospect of a securities fraud charge themselves. This virtually guarantees that neither Dirks nor any other securities professional will invest his time and energy in investigating allegations of corporate fraud. Such a result is contrary to the common understanding of the role of the securities analyst and contrary to common sense. It is based on the explicit assumption that it is illegal to hope for financial reward for diligent service to the community, such as the exposure of crime, an assumption without support in the securities laws and contrary to longstanding public policy which supports rewards for those who expose crime. As Professor Lorie of the University of Chicago Business School has said, "[w]e should see to it that the Raymond Dirkses of the future get gold medals rather than censure and other punishment." Lorie, *Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy: A Comment*, 9 J. Leg. Stud. 819, 822 (1980).

B. Dirks Did Not Acquire a Fiduciary Duty by Virtue of His Position as an Employee of a Broker-Dealer

The court below also found that Dirks aided and abetted violations of Rule 10b-5 and Section 17(a) because, as an employee of a registered broker-dealer, he "breached his duty to the Commission and to the public not to misuse insider information." (Pet. App. C-1) Indeed, this was the sole express ground stated by the court in its two-judge judgment and was deemed by Judge Wright to be the "more important" ground for decision. (Pet. App. A-27)[18] This novel holding of the Court of Appeals expands the scope of Section 10(b) far beyond the limits set by this Court's decision in *Chiarella*. This is the only decision that has ever found that a broker-dealer has a general duty to the public and to the SEC that satisfies the requirements of *Chiarella*.[19]

There is no such duty. Although the court below purported to be affirming a conclusion of the Commission, the Commission never found that petitioner owed or breached any duty to the public or to the Commission. Such a position was never urged upon the Commission by the Division of Enforcement and the Commission itself did not take such a position in its decision or before the Court of Appeals. Moreover, the imposition by the Court of Appeals of such a duty is an unwarranted expansion of Section 10(b) and is inconsistent with *Chiarella*.

The basis, in Judge Wright's opinion, for imposing such a duty, is that broker-dealers are obligated to meet a high ethical standard which "restrains broker-dealers not only in their dealings with their customers, but also in their dealings with the SEC and the public at large." (Pet. App. A-29) Thus, regardless of how Dirks obtained his information, in Judge Wright's view he "violated his duties to the SEC and the public by failing to report promptly what he knew." (Pet. App. A-31)

[18] This ground for decision was wholly separate from the finding that Dirks acquired fiduciary duties from insiders. (*See* Pet. App. A-27)

[19] The cases since *Chiarella* which have found a breach of duty have limited that duty to a specific group of identifiable persons. *See, e.g., United States* v. *Newman*, 664 F.2d 12, 16-19 (2d Cir. 1981); *SEC* v. *Murphy*, 626 F.2d 633, 652 n.23 (9th Cir. 1980); *SEC* v. *Lund*, [1981-82] Fed. Sec. L. Rep. (CCH) ¶ 98,428 (C.D. Cal. 1982).

Judge Wright noted that the Securities Exchange Act of 1934 imposes on broker-dealers "myriad duties not imposed on corporate officers or other members of the general public." (Pet. App. A-27) But he nowhere found in that scheme of regulation any express duty of disclosure owed by broker-dealers to the public or the SEC. In fact, even Judge Wright conceded that "the main focus of the SEC's regulation of broker-dealers has been to ensure that broker-dealers treat their customers honestly and fairly." (Pet. App. A-28)[20]

Judge Wright instead conjured up this duty out of the statement by this Court, in *United States* v. *Naftalin*, 441 U.S. 768 (1979), that an objective of the securities laws is to achieve a high standard of ethics "in every facet of the securities industry," *id.* at 775. (Pet. App. A-28) Judge Wright also noted that the legislative history of the securities laws indicates that they were designed to prevent the sale to the public of unsound or worthless securities. Judge Wright found that "Dirks' conduct was fundamentally inconsistent with 'prevent[ing] further exploitation of the public by the sale of unsound, fraudulent, and worthless securities.'" (Pet. App. A-30) From these general

[20] Judge Wright also cited two court cases, an SEC decision, and a law review article for the proposition that special duties are imposed on broker-dealers. This authority stands for nothing more than the proposition that broker-dealers owe a special implied duty of fair dealing to their *customers*. *See Charles Hughes & Co.* v. *S.E.C.*, 139 F.2d 434 (2d Cir.), *cert. denied*, 321 U.S. 786 (1943); *In re Duker & Duker*, 6 S.E.C. 386 (1939); Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers*, 57 Corn. L. Rev. 869, 876-81 (1972). The other case cited by Judge Wright, *O'Neill* v. *Maytag*, 339 F.2d 764 (2d Cir. 1964), stands for the proposition that a nondeceptive breach of fiduciary duty "created with particular reference to the purchase or sale of securities" might be actionable under Rule 10b-5, even though other nondeceptive breaches might not be. Although the court indicated in *dictum* that broker-dealers and investment advisers might have such duties, it never suggested that they have such duties toward anyone other than their customers.

statements of legislative intent, and nothing more, Judge Wright has created a duty owed by broker-dealers and their employees to all members of the public and the SEC.

This decision has enormous potential ramifications for broker-dealers, as well as for the rest of those professionals who deal "in every facet of the securities industry" and who should be held to high ethical standards. By Judge Wright's logic, the fiduciary duty imposed on Dirks can be imposed on any persons who are engaged in any facet of the securities industry, and who owe the investing public an obligation to behave ethically. The same duty could be found to apply to lawyers and accountants who deal with the issuance of securities, to financial columnists who are involved intimately with the workings of the market, and, for that matter, could have been found to apply to financial printers like Chiarella.

The decision below is completely inconsistent with *Chiarella*. In *Chiarella* this Court required that there be a specific relationship giving rise to a fiduciary duty to disclose before liability can be imposed for nondisclosure under the antifraud provisions of the securities laws. Instead of finding such a specific duty on Dirks' part, the court below has equated ethical *dicta* with fiduciary duties, and has converted an alleged breach of ethics into fraud. If, as the court below held, a fiduciary duty required under *Chiarella* means nothing more than the duty to behave in an ethical fashion, with the decision as to what is ethical to be made in each case by the judge, without reference to a predetermined legally prescribed standard, the requirement of a fiduciary duty will be meaningless, and perhaps even unconstitutionally vague, *see United States* v. *L. Cohen Grocery Co.*, 255 U.S. 81, 89-93 (1921). In the guise of finding a duty under *Chiarella*, the decision below effectively eviscerates that decision, and should be reversed.

II. The Unverified Rumors That Dirks Learned of Did Not Constitute Material "Facts"

A. The Antifraud Provisions of the Securities Laws Apply Only to "Facts"

The courts have uniformly held that Section 10(b), Rule 10b-5, and Section 17(a) apply only to misstatements or omissions of "material fact," *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976), and not to rumors, allegations, and other unverified information. *See SEC* v. *Monarch Fund, supra*, 608 F.2d at 942; *Hassig* v. *Pearson*, 565 F.2d 644 (10th Cir. 1977); *Marx & Co.* v. *The Diner's Club, Inc.*, 550 F.2d 505 (2d Cir.), *cert. denied*, 434 U.S. 861 (1977); *Alaska Interstate Co.* v. *McMillian*, 402 F. Supp. 532, 567 (D. Del. 1975); *Ruszkowski* v. *Hugh Johnson & Co., Inc.*, 302 F. Supp. 1371, 1376 (W.D.N.Y. 1969).

The Court of Appeals nonetheless affirmed the Commission's finding that the information disseminated by Dirks consisted of "material facts." What Dirks disclosed were not "facts"—they were unverified rumors and allegations—and the Commission and the court improperly held that they were "facts" for purposes of the securities laws.[21]

B. The Allegations and Rumors Reported to Dirks Were Not "Facts"

1. Unconfirmed Claims of Fraud Denied by Management Are Not Facts

The Commission stated in its opinion that even though neither Secrist nor Dirks' other sources offered hard evidence, the

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[21] Indeed, in two reported cases dealing with some of the same Equity Funding allegations heard by Dirks, two courts have held that the allegations were rumors, not facts, and that there was no obligation to disclose them. *See Pachter* v. *Merrill Lynch, Pierce, Fenner & Smith*, 444 F. Supp. 414, 422 (E.D.N.Y.), *aff'd mem.*, 594 F.2d 852 (2d Cir. 1978); *Wiener* v. *Oppenheimer & Co.*, [1979] Fed. Sec. L. Rep. (CCH) ¶ 96,764, at 95,001 (S.D.N.Y. 1979).

allegations nonetheless had "objective indicia of reliability" because they came from a former vice president of EFLIC; were specific and detailed; and because Secrist identified others who he said could corroborate his story. (Pet. App. B-14 to B-15) Judge Wright likewise stated that at least by the end of Dirks' investigation he had heard allegations in "enough specificity to satisfy Rule 10b-5." (Pet. App. A-34) These factors provided no such "indicia of . . . reliability."

First, that Secrist was a former employee of EFLIC was in fact cause for suspicion of his motives. Dirks found out that Secrist had been fired by the company and was lying when he had claimed to have resigned in protest over company policies. Indeed, virtually every witness who learned that Secrist was the source of the rumors testified that he tended to discount them as the allegations of a disgruntled ex-employee. (J.A. 126-27; R. 2137, 7180, 7193-94, 8743-45, 10,030)

Second, that Secrist's story was detailed did not make it reliable. Quite the contrary. Dirks quickly checked out many details of Secrist's story and found that they were wrong.[22] Moreover, Secrist himself discounted his information, saying that only 1% was based on his own experience, and that many of his conclusions were pure deduction. (R. 710-11, 718, 743) Given the fantastic nature of Secrist's story, Dirks' repeated discoveries that significant aspects of the story were erroneous obviously tended to discredit the allegations.

Finally, that Secrist identified others whom he thought might corroborate his story did not add much to his credibility because the others were themselves generally only aware of the same rumors Secrist was aware of, had no hard evidence,

[22] These included a statement that EFLIC's salesmen-to-sales ratio would prove the existence of fictitious insurance (R. 1881-83), an assertion that EFLIC's business had doubled between December 15 and December 31 (R. 5424-27), and an allegation that Haskins & Sells had dropped the EFLIC account. (R. 1448-49, 5413, 5415)

and indeed had no knowledge of Equity Funding's current practices.[23]

More important, however, is that these claims of "indicia of reliability" totally ignore the critical facts.

First, of the eight allegations regarding Equity Funding made by Secrist, only three—relating to the creation by Equity Funding of fictitious insurance policies and certificates of deposit—turned out to be true. Each of the remaining major allegations, which included allegations that Equity Funding only had $10,000,000 in assets, that it had fictitious real estate on its books and was selling it through limited partnerships, and that Haskins & Sells had refused to continue as auditor for EFLIC, was as believable, if not more so, and had the same "indicia of reliability" as the first three. And yet, each of these allegations ultimately turned out to be false.[24]

Second, each of the allegations was denied in detail by the management of the company—including persons who were in a position to know and were not alleged by Secrist to be implicated in the alleged fraud. (Secrist was wrong here, too, because Goldblum, the Chairman and President of Equity Funding, was involved although Secrist had said he was not.)

What Dirks knew by the end of his investigation were not facts. All that he knew was that a fired employee of Equity Funding told him a detailed, inherently unbelievable (and, it turned out, partly true and partly false) story of fraudulent activities at the company, but had no firm evidence of any such widespread fraud. He also knew that several other former

[23] Moreover, Secrist's characterization of these other persons as people who were "wild, and erratic, and given to elaborate fantasies" (R. 710-11, 718, 743, 757) did not exactly suggest that everything they said should be taken at face value.

[24] Judge Wright sought to overcome this problem by asserting that the ALJ found that by March 23 Dirks had separated out the true from the false, and was only relating those allegations he knew to be "substantially true." (Pet. App. A-34 n.25) In fact, the ALJ made no such finding. (I.D. 97-103, J.A. 242-46)

employees had heard of such a fraud, and believed they might have been involved in suspicious activities a few years earlier, but also had no evidence of continuing fraud. Dirks also knew that top management of Equity Funding denied the allegations completely and had seen evidence presented by management that tended to discredit the allegations. Dirks had spoken with Equity Funding's present and past auditors, both of whom told him they could not see how such a massive fraud could be carried out.

While Dirks plainly did not believe that the story was definitely untrue, and certainly did believe that it merited further investigation, he obtained no proof of fraud at Equity Funding. Indeed, Dirks' purpose in talking to others, including the *Journal*, Equity Funding's auditors, and members of the investment community, was to bring those persons' resources to bear in the investigation, to either confirm or refute the allegations. (J.A. 49-50, 56-57, 58, 71-72) At most Dirks' professional instincts, honed over years in the securities business, told him that this was a story which might well prove true upon further investigation. While Dirks' suspicions were ultimately proven correct, however, this was not until well after trading in Equity Funding securities was suspended. During his investigation, all that Dirks had to offer were unverified allegations and his best professional hunch.

2. The Allegations Were Not Treated as "Facts" by Those Who Heard Them

That these allegations were nothing more than unverified, and inherently improbable, stories, is confirmed by the reactions of sophisticated analysts, investors and officials who heard the allegations regarding Equity Funding from Dirks or otherwise.

(a) The allegations were by and large rejected by the investment community. Although some investors who heard the allegations sold their Equity Funding stock, many others

either did nothing or actually purchased additional Equity Funding stock. For example:

—Dirks' investigation was described in detail to Gene Mercy of Goldman, Sachs, who had previously heard the allegations and had bought a large block of Equity Funding stock in response. (R. 4562-63, 4566, 4578-83, 4629, 4642-44; 6447, 6486, 6490, 6514, 6521-24; Division Ex. 43, R. 3379, 3422) Mercy personally owned $55,000 in Equity Funding convertible debentures which he never tried to sell. (R. 6436, 6482) Goldman, Sachs continued to trade in Equity Funding stock throughout March 1973. (Division Exs. 42, R. 3378, 3406, and 43, R. 3379, 3422)

—On March 26 and 27, Dirks related the allegations to Harold Richards of Fidelity Corporation of Virginia, which Richards described as Equity Funding's largest shareholder. Fidelity did not sell any of its Equity Funding stock. (J.A. 65; R. 1393-96, 1794-96)

—Dirks described the allegations to Jerome Fine of Steinhardt, Fine and Berkowitz, which afterward purchased 88,000 shares of Equity Funding stock. (R. 1402-04, 1801)

—On March 23, Goldblum discussed the allegations with Laurence Tisch, President of Loews Corporation, a major investor in Equity Funding. Thereafter, Tisch had Loews buy 30,000 additional shares of Equity Funding on March 23 and place an order for 500,000 more shares on March 26. (R. 8486-88, 8563-64; Division Ex. 42, R. 3378, 3406 and 43, R. 3379, 3422)

The evidence shows that many other members of the investment community heard some or all of the allegations of fraud and wrongdoing at Equity Funding prior to the halting of trading on March 27.[25] There is no evidence that any of these people thought the allegations substantial enough to report to any regulatory agency or, where these people bought or sold

[25] This evidence is discussed in detail at pages 20-21, 24-25, 28-29, and 32-35 of Petitioner's Brief in the Court of Appeals.

Equity Funding stock in March 1973, to the other party to the transaction.

(b) The allegations were not considered to be "facts" by the regulatory agencies with jurisdiction over Equity Funding. The improbable nature of these allegations is demonstrated not only by the fact that virtually no one in the investment community, upon hearing the allegations, sought to bring them to the attention of the regulatory bodies with jurisdiction over Equity Funding, but also by the fact that when these regulatory bodies were informed of the allegations, they did not consider them substantial enough to act on or, if they investigated the matter, could not corroborate them.

Secrist himself advised the New York Insurance Department of his suspicions during a two-hour meeting on the same day he met with Dirks for the first time. Other than passing on the allegation to the California Insurance Department and eventually advising the SEC and New Jersey Insurance Department, the department took no action.

The California Insurance Department relayed these allegations to the SEC on March 9. (J.A. 91-98; R. 7746, 7749-50; Boston Co. III Exs. DDD, R. 7619, 7619, and EEE, R. 7635, 7635) The SEC regional office attorney told the Department that the source of the reports was a disgruntled ex-employee, that they had been investigated in the past, and that it would be at least two to three months before any active work could be done.[26] (J.A. 92-98; R. 7674-76, 7712, 7716; Boston Co. III Ex. HHH, J.A. 171-72, R. 7702, 7717)

[26] The California Insurance Department, while not believing the allegations (R. 7190-91, 7194; 7468-69), reported them to the Illinois Insurance Department, which had jurisdiction over EFLIC, an Illinois corporation. (R. 7176-77, 7230; 7282-84, 7292) The Illinois department, while finding the allegations incredible, sent two examiners to California to conduct EFLIC's periodic examination. (R. 6976, 6989-95, 7002-04, 7011-12, 7140-42; Bristol Ex. F, p. 1, R. 6977, 6979) These two examiners arrived on March 13, and by the time they were joined by a California examiner on March 21, had found no evidence of fictitious insurance. (R. 7018; Bristol Ex. F, p. 2, R. 6977, 6979)

Goldblum, the President of Equity Funding, met with two staffers of the New York Stock Exchange on March 23, at their request, to explain the rumors. After hearing his explanation, no further action was taken. (R. 8502-05)

Blundell of *The Wall Street Journal* spoke on March 23 with Stanley Sporkin in Washington and Ralph Erickson in Los Angeles of the SEC's Division of Enforcement and told them the allegations in detail. (J.A. 63, 132-33; Dirks Ex. R, J.A. 163-64, R. 7949, 7950) The SEC did nothing for several days. (R. 8350, 8454-56; 8703-05)

Stanley Sporkin, who was then Deputy Director of the SEC Division of Enforcement, later explained to Congress why he waited nearly a week after Blundell's detailed account to press for the suspension of trading in Equity Funding securities:

> I just wanted to emphasize that I think the Chairman had mentioned, that we cannot suspend trading merely on the basis of some rumor. We must have more information than that. In this case, in fact, a lot more had been done at that time. The [NYSE] had called Equity Funding in and Mr. Goldblum of the company had denied these rumors. We were really in a quandry on the week of March 26 about what we should do. We had no real verification of the facts.

Hearings Before Subcomms. of the Senate Comm. on Appropriations, 93d Cong., 1st Sess. 90 (1973) (Boston Co. III Ex. JJJ, p. 90, R. 8264, 8390)

Even when, on March 27, the New York Stock Exchange suspended trading in the company's stock, it did so as a result of disorder in the market being caused by the rumors, but did not have any proof that the rumors were true (R. 8841-43, 8923-24, 8927; Bristol Exs. G, R. 8784, 8796, and K, R. 8784, 8796), and later learned that the SEC and state insurance departments had no such proof either. (R. 7374-76; 8846-49, 8855-56, 8862-65, 8869-70, 8908-11; Bristol Ex. K, R. 8784, 8796) The Exchange, after reviewing transcripts of Dirks' testimony before the SEC, still believed that the claims were "not fact." (R. 9119-20; Bristol Ex. H, R. 8784, 8796) Indeed, when the SEC suspended trading in the stock on March 28, the

SEC official investigating the matter, after talking with Dirks for two days, was not convinced that the rumors were true. (I.D. 133-35, J.A. 269-70; R. 8631, 8639) And when trading was suspended in Equity Funding stock, the *Journal* still did not believe that it had sufficient evidence on which it could publish a story. (R. 1366-67, 1940; R. 8700-02, 8748)

In fact, the ALJ conceded that it was not until March 30 that facts were developed by anyone which made the allegations even "highly probable." (I.D. 133, 135, J.A. 268-69, 270)

* * *

The difference between this case and a true "fact" case like *In re Cady, Roberts & Co., supra*, or *SEC* v. *Texas Gulf Sulphur Co., supra*, is obvious. When one of Curtiss-Wright's directors in *Cady, Roberts* tipped people about the company's cut in dividend, no one bought the stock. They knew what he said was reliable and what it meant. When Texas Gulf insiders tipped people about mineral finds, no one sold the stock. Again, they knew the information was reliable and what it meant. In contrast, the reaction in the investment community, as well as regulatory agencies, in the present case makes it clear that the Secrist allegations, which were denied by Equity Funding management, were simply not "facts."

The effect of holding that uncorroborated allegations of fraud are "facts" which must be disclosed, will substantially deter the independent investigation of fraud allegations by independent analysts who, as noted, are often in a position to make such investigation. Any time an analyst uncovers or develops negative allegations or rumors on a company, he will be required to make public disclosure of the allegations (even though that is practically impossible with respect to unverified stories) or remain silent. If he seeks to explore the allegations, the dissemination of the story may cause some of those who hear it to credit the allegations and sell their stock. If it turns out that the allegations are well founded, or even if they are not but their effect is that the stock is worth less than the price at which it was sold, it can be expected that the purchasers will

turn around and sue the analyst under Rule 10b-5. Rather than risk this, the safe course for the analyst will be to ignore the allegations. That will simply assure that the true facts will remain hidden. This result is not required under the antifraud provisions of the securities laws, and is contrary to sound public policy.

CONCLUSION

For the foregoing reasons, the decision below of the Court of Appeals should be reversed.

Respectfully submitted,

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