May 29, 1983

Mr. Justice:

From: Dave Van Zandt

Re: Dirks v. SEC, No. 82-276

LFP's Majority Draft

LFP's rendition of the facts paints Dirks as an altruistic actor. In footnote 2, LFP implies that Dirks received little financial reward for his efforts. Part II asserts that In re Cady Roberts, 40 S.E.C. 907 (1961), and Chiarella established that a duty to disclose or to refrain from trading arises from the existence of a fiduciary relationship. Pp. 5-6. This is based on the common law duty an insider owes to the corporation's shareholders not to trade in securities of the corporation by the use of inside information. P. 5 and n. 9.

Part IIIA begins by noting the difficulties that the SEC has faced in policing this rule when tippees of corporate insiders are involved. P. 7. The SEC's view in this case that the tippee inherits the In re Cady Roberts duty to disclose or refrain simply because the information is material and nonpublic was rejected in Chiarella: that case rejected the parity of information theory. Pp. 8-9. In footnote 14, [illegible]ates that the Court drew no distinction in Chiarella between "market" and "inside" information. Mere receipt of inside information from an insider does not create a special relationship. P. 10, n. 14. Imposing a duty on a person simply because he is in a position to

receive that information could inhibit the valuable role of market analysts in bringing information to the market.

Footnote 17 is a critical factual footnote in the opinion. It first acknowledges that the information Dirks uncovered needed no analysis or insight to transform it into devastating material information. Then, in an unsupported paragraph, the footnote asserts that "Dirks' careful investigation brought to light a massive fraud at the corporation. ... But for Dirks' efforts, the fraud might well have gone undetected longer." P. 11, n. 17.

Part IIIB states that insiders may not pass on inside information to a corporate outsider for "the same improper purpose of exploiting the information for their personal gain." P. 12. The tippee's duty to disclose or to refrain is derivative from the insider's duty. P. 12. A tippee assumes the duty only when the information is made available to him improperly, that is, only when the insider has breached his fiduciary duty to shareholders by disclosing the information to the tippee and the tippee knows there has been a breach. Pp. 12-13. In footnote 20, LFP states that Dirks' activities may have been unethical. He also states "[n]or do we imply an absence of responsibility to disclose promptly indications of illegal actions by a corporation to the proper athorities--typically the SEC and exchange authorities in cases involving securities." P. 13, n. 20. He then states that the SEC at oral argument conceded that Rule 10b-5 does not impose any obligation to report fraud to the SEC before trading. Disclosing the fraud to the SEC would not have satisfied Dirks' disclose or refrain duty.

Part IIIC poses the issue as whether Secrist violated his duty by disclosing to Dirks. Often an insider's disclosure to an analyst will raise the question whether the information is material. P. 14. The insider may mistakenly believe that the information is not material enough to affect the market. P. 15. Whether such disclosure is a breach depends "in part on the purpose or good faith of the insider who made the disclosure. Absent an improper purpose, there has been no breach of duty to stockholders." P. 15. Bad faith may be shown by circumstances that suggest that the insider benefits the tippee in return for some other consideration, or even when the tip is a gift. The purpose of the disclosure to the tippee is critical.

Part IV applies this purpose test to this case. Dirks was a stranger to Equity Funding with no preexisting fiduciary duty to its shareholders. Nor did Secrist or other Equity Funding employees Dirks interviewed violate their fiduciary duties. They received no monetary or personal benefit nor did they have the purpose of making Dirks a gift of valuable information. The tippers were motivated by the desire to expose the fraud.

Discussion

LFP is following up on his efforts in Chiarella to limit the SEC's use of §10(b) to stop insider trading and unfair dealing. He focuses on the tipping relationship between the insider and the tippee. In order for the tippee to be liable for trading, the insider must have breached his fiduciary duty to shareholders and must have had some bad purpose in giving the tippee the information.

The argument is tricky and complex; it is also full of holes. First, LFP states that the relevant duty is that of the insider not to trade in the corporation's securities on inside information. He later transmutes sub silentio this duty into a duty not to give outsiders corporate information for bad purposes. If the first duty, however, is the relevant one, then Secrist breached it. The record states that he gave Dirks the information fully intending that Dirks would give it to his clients who in turn would trade on it forcing down the price of the stock. Thus, shareholders to whom Secrist had a duty were injured. Secrist did indirectly, precisely what he could not do directly: trade in the stock on inside information.

Second, part IIIC states that the purpose for which Secrist disclosed the information is determinative. If LFP means exactly this, then he has misapplied his own test. The purpose of the disclosure was to permit Dirks' clients to sell their stock, avoid massive losses, and thereby drive down the prices. LFP must have a broader purpose in mind: the purpose of exposing the fraud. This is altruistic, of course, but it is altruism bought by shifting the loss unto those not privileged enough to be Dirks' clients. LFP sets up a smokescreen by saying that it may be unclear whether the information is material. There is no doubt here. Regardless, Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), requires for Rule 10b-5 liability both that the information be material and that the trader know it to be inside, material information. There is no exception for trading on inside material information with a "good" or "altruistic"

purpose. This purpose test is quite confusing, and I haven't figured out its ramifications yet.

In drafting a dissent, I at present plan to take the following approach. Part I will report facts missing from LFP's opinion as to Dirks' actions and as to Secrist's purposes in revealing the information. Part II will argue that Secrist did violate his fiduciary duty to shareholders indirectly by passing on information that he knew would be used to trade to the disadvantage of shareholders. Part III will suggest that they are other ways of exposing corporate fraud that do not involve the same unfairness to innocent shareholders.