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

---

REPLY BRIEF FOR PETITIONER RAYMOND L. DIRKS

DAVID BONDERMAN
Counsel of Record
LAWRENCE A. SCHNEIDER
ERIC SUMMERGRAD
ARNOLD & PORTER
1200 New Hampshire Ave., N.W.
Washington, D.C. 20036
(202) 872-6700
Attorneys for Petitioner Raymond L. Dirks

March 1983

PRESS OF BYRON S. ADAMS PRINTING, INC., WASHINGTON, D.C.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

No. 82-276

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

---

REPLY BRIEF FOR PETITIONER RAYMOND L. DIRKS

As the Court of Appeals noted in its decision below, "[l]argely thanks to [Petitioner] Dirks, one of the most infamous frauds in recent memory was uncovered" almost exactly ten years ago. (Pet. App. A-3) In the ensuing litigation everybody from the perpetrators of the crime (J.A. 115-17) to the Commission itself (Pet. App. B-26) has acknowledged Dirks' preeminent role in the uncovering of criminal wrongdoing at Equity Funding. Moreover, throughout the litigation it has been undisputed—indeed, it could hardly be otherwise on the record—that Dirks uncovered the fraud after various regulatory agencies, most particularly the SEC, had failed to do so despite numerous opportunities. (Pet. App. A-3)

Indeed, the Solicitor General views Dirks' activities as having been of such importance in the ferreting out of criminal misconduct that he has filed an *amicus* brief urging reversal in this case, arguing that the decisions below will have a serious negative impact on criminal law enforcement by deterring analysts who, like Dirks, would seek to investigate allegations of corporate crime. (Sol. Gen. Br. at 26-28)

Remarkably, the Commission's counsel argue for the very first time that, notwithstanding the record and the decisions below to the contrary, Dirks did nothing to uncover the Equity Funding scandal. The Commission's counsel now claim that the fraud was about to collapse of its own weight anyway (SEC Br. at 38-39 & n.46), that the regulatory agencies were hot on the tracks of the conspirators (SEC Br. at 5), and that Dirks' activities in fact delayed exposure of the fraud. (SEC Br. at 38) The Commission's counsel suggests that rather than the perpetrators of the fraud who sold worthless stock to the public being the villains, it was Dirks who "victimized" the shareholders by disseminating the allegations of fraud to the market, the auditors, and the press. (SEC Br. at 30)

These claims are completely wrong and totally unsupported by the record or the decisions below.[1]

[1] It is simply not possible, given the limitations of space—and not useful given the general irrelevance of the SEC's factual misstatements to the legal issues at hand—to discuss in detail the serious errors, misleading statements, and omissions in the SEC's brief. To the extent these claims are not discussed in this reply, we believe that the Court will find that the statement of facts in our opening brief is fully supported by the record cites therein and, indeed, by the findings of the Administrative Law Judge, the Commission, and the court below. The SEC's recitation is not. In truth, it appears that the SEC's present counsel, none of whom participated in the original hearings, either do not know the factual record or do know it but recognize that the factual findings of the Commission and the Court of Appeals have a serious adverse impact on their arguments. *Cf. SEC* v. *McDonald*, 15 Sec. Reg. & L. Rep. 321, 322 (1st Cir. Feb. 11, 1983) ("We also note, in passing, that inconsistencies [in its arguments] do not bother the Commission.").

Commission counsel's mischaracterization of Dirks' role is part and parcel of their efforts to have this Court ignore the crucial distinctions between the exposure of serious crime that took place here and garden variety "tippee" cases. Rather than dealing with the facts of this case, the Commission single-mindedly pursues its self-appointed task, previously rejected by this Court in *Chiarella* v. *United States*, 445 U.S. 222 (1980), of assuring parity of information, to the exclusion of the important law enforcement goal of exposing serious crime. Thus, as a substitute for analysis, the Commission uses spit words like "inside information" and "tippee" (*see, e.g.*, SEC Br. at 23-25) even though the information involved here was not confidential corporate "inside" information and neither the Commission's conclusory labels, nor the theory of "tippee" liability that the Commission seeks to rely upon, are in any way applicable here. The result, unless the decision below is reversed, will be to actively discourage the disclosure of information concerning corporate fraud.

We deal with the Commission's contentions seriatim:

1. *Chiarella* Applies To This Case

The Commission does not overtly dispute that the controlling principles enunciated in *Chiarella* v. *United States*, 445 U.S. 222 (1980)—that the antifraud provisions of the laws are designed to catch fraud, and that "[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak," *id.* at 235—apply here. Instead, the Commission suggests, without quite saying so, that *Chiarella* only applies to the use of "market information." But as the Solicitor General points out in his *amicus* brief, "[a]lthough *Chiarella* dealt with nondisclosure of 'market information' . . . the Court's decision rested on general principles governing all cases of nondisclosure under Section 10(b)." (Sol. Gen. Br. at 15-16 n.7)[2]

[2] Thus, the Commission's assertion that we and the Solicitor General "concede that there is no conflict between the Commission's

2. The SEC Has Conceded Much Of Its Case

The Commission asserts that under *Chiarella* a duty to disclose may arise under two circumstances. First, it states that the duty may arise where there has been misappropriation of information. (SEC Br. at 23-24 & n.29) But it concedes that there has been no misappropriation here. (*Id.*)

Second, it states that a duty to disclose may arise under the "traditional prohibition . . . against trading on inside information . . . which imposes liability on both insiders and their tippees." (SEC Br. at 23-24) The Commission does not contest the fact, however, that Dirks was not an insider of Equity Funding. In addition, the Commission concedes that Judge Wright's primary theory for upholding the Commission's decision—that Dirks owed a special duty of disclosure as an employee of a broker-dealer—cannot be a basis for affirmance of the decision below. (SEC Br. at 21-22 n.27)

Thus, the only remaining disputed question is whether Dirks was a "tippee" of Equity Funding insiders who inherited a duty of disclosure from them. As discussed in our opening brief and below, Dirks was not a "tippee," as that term is used under the federal securities laws, and had no duty to disclose.

3. Dirks Did Not Obtain Information Through A Breach Of An Insider's Duty And Accordingly, Under *Chiarella*, Had No Duty To Disclose

In "tippee" cases, involving the transmission of "inside" information—that is, information intended for a corporate purpose and properly maintained as confidential—to outsiders, the finding of a duty to disclose has not been difficult. The outsiders have either received the information improperly in breach of an insider's duty not to disclose, or have been proper-

decision here and *Chiarella's* actual holding," (SEC Br. at 22), is incorrect. We and the Solicitor General have both asserted that the decisions below are in direct conflict with the rule of law established by *Chiarella*. (*See* Pet. Br. at 18-27, 31-34; Sol. Gen. Br. at 18-26)

ly entrusted with the information for a corporate purpose, but have misappropriated the information by using it for trading. (Pet. Br. at 19-23; Sol. Gen. Br. at 20-24) The fundamental difference between those cases and this one is that it does not involve "inside" information, which the law properly allows to be kept secret in order to benefit the company involved. The information which Dirks received was information about a massive corporate crime, of which the law encourages, indeed requires, the disclosure. As such, Dirks' sources were free to reveal the information. The Commission does not contest that disclosure in and of itself was legal. (SEC Br. at 25) Nor does the Commission contest the fact that Dirks, having legally acquired the information, did not then misappropriate it when he used it. (SEC Br. at 23-24 & n.29)

(a) Absent A Breach Of Duty By An Insider, An Outsider Receiving Non-Confidential Information Has No Duty To Disclose

The Commission nonetheless contends that as a result of acquiring information from Secrist, a former officer, Dirks became a "tippee" with duties to disclose. The Commission is, however, ambivalent about what it means. On the one hand, it presses the theory that was applied by the Commission in its decision, argued by the Commission's counsel in the Court of Appeals, and applied by the Court of Appeals: that the mere act of disclosure of non-public information by corporate insiders, regardless of how proper and legal, conferred on Dirks duties of disclosure. (SEC Br. at 34-35 n.41) To the extent that this is the Commission's argument, it is completely inconsistent with this Court's holding in *Chiarella* that the mere possession of non-public material information does not give rise to a duty to disclose. *See* 445 U.S. at 233.[3]

[3] The Commission has no authority for this proposition, and simply suggests that this Court in *Chiarella* did not mean to limit "tippee" liability to those circumstances where an insider breaches a duty in making disclosure. (SEC Br. at 34 n.41)

(b) Secrist Breached No Duty

On the other hand, the Commission devotes the bulk of its brief to arguing a brand new theory—that Dirks' principal source, Ronald Secrist, did breach a fiduciary duty when he made disclosure to Dirks, and that the disclosure was therefore wrongful. The Commission agrees that Secrist was under no duty to Equity Funding to keep the information about criminal fraud a secret (SEC Br. at 25), but argues that even so the disclosure constituted a breach of duty to potential shareholders of Equity Funding. (SEC Br. at 24, 30-31)

This wholly novel theory of liability is being advanced by the Commission for the first time in this Court. It was never presented to the Administrative Law Judge or the Commission, neither of whom predicated Dirks' liability on any breach of duty by Secrist. (*See* SEC Br. at 34 n.41) Indeed, the court below specifically noted that the SEC had failed to claim any such breach. (Pet. App. A-23 n.15; *see* SEC Court of Appeals Brief at 50)

The first hint of this new theory, which the SEC has adopted as virtually its sole basis for affirmance, appears in a footnote contained in Judge Wright's opinion below. He suggested that "[d]espite the SEC's failure to dispute the issue, it is not clear that California law would permit Dirks' informants to secretly provide information about Equity Funding to Dirks with reason to believe that he would profit by it." (Pet. App. A-23 n.15) Yet even Judge Wright went on to note that no applicable case had ever held such actions to be a breach of duty.[4]

This Court need not consider whether Dirks would be liable if Secrist had breached a duty. As the Commission affirmatively argues elsewhere in its brief, where a theory of liability was neither considered by the Commission nor presented to the Court of Appeals, it may not, under *SEC* v. *Chenery Corp.*, 332 U.S. 194, 196 (1947), be relied upon to support the decision below. (SEC Br. at 21-22 n.27)

[4] Judge Wright stated, moreover, that since his theory of liability did not depend on such a finding, it was unnecessary to decide if Secrist or the other sources had breached any duty. (*Id.*)

But in any case it is clear that the theory of Commission's counsel is wrong. Secrist's disclosures did not, in fact, constitute a breach of duty to potential shareholders.

Secrist, as a former insider, owed two duties to potential shareholders of the company. First, he himself could not have traded in Equity Funding stock without making full disclosure of material facts in his possession. As a former insider, he was required to disclose when dealing with the shareholders for personal profit. *See Chiarella*, *supra*, 445 U.S. at 227-28; *Strong* v. *Repide*, 213 U.S. 419, 431-35 (1909).[5] But it is undisputed that Secrist did not trade in Equity Funding stock or "knowingly confederate" with others to trade for their mutual benefit, *see Jackson* v. *Smith*, 254 U.S. 586 (1921); *Jackson* v. *Ludeling*, 88 U.S. 616 (1874). In fact, Secrist scrupulously avoided engaging in any such trades. (J.A. 15)

Secrist's second duty to the shareholders was "to administer the corporate affairs *for the common benefit of all the stockholders*, and exercise [his] . . . best care, skill, and judgment in the management of the corporation business." 3 *Fletcher Cyclopedia Corporations* § 838, at 143 (Perm. ed. 1975) (emphasis added). This duty of care is owed by corporate officers to the shareholders collectively, and "is only another way of stating that they are trustees for the corporation." *Id.* at 144. In other

[5] This would have been true, as the Solicitor General points out, "regardless of the classification of information as inside information, market information, or evidence of crime." (Sol. Gen. Br. at 19 n.12) It is interesting to note that the Commission extensively quotes the Solicitor General on this point, but carefully deletes the words "market information" from the quote. (SEC Br. at 29) While the Commission would like to leave the impression that it is stating a theory only applicable to "inside" information, and thus distinguishable from *Chiarella*, its theory would in fact be applicable to the disclosure of any nonpublic information by an insider.

words, Secrist's duty was to consider what was in the best interests of the entire "corporate family." Consistent with that obligation, Secrist made disclosure because he reasonably believed that it was the only effective way to expose the fraud, and that exposure of the fraud was in the best interests of the corporation, its shareholders, and the public. (J.A. 15-16, 26-27)

That some shareholders lost most of their investment as a result in no way suggests that the disclosure was improper. As the Solicitor General points out, "[i]t was inevitable that the Equity Funding fraud would have victims" (Sol. Gen. Br. at 30), since regardless of what Secrist did to expose the fraud the shareholders were going to be left with worthless stock. Secrist and Dirks did not create victims. Instead, as the Solicitor General states, they prevented further victimization by the perpetrators of the fraud. (Sol. Gen. Br. at 30) Had Secrist and Dirks not acted, and had the fraud continued unabated, more phony insurance would have been created and sold off,[6] more legitimate assets would have been absorbed by the fraud, more legitimate companies would have been acquired, more embezzlement would have taken place, and more bank loans and other credit would have been fraudulently obtained.

The Commission totally fails to explain how Secrist's purpose of exposing criminal fraud could possibly conflict with any fiduciary duty. As noted, it was not in Secrist's power to determine *whether* investors would be injured. That was a *fait accompli* beyond his control. The only question was *when* the scheme would be brought to a halt. Secrist chose sooner, rather than later, and thereby advanced the welfare of the

---

[6] As the Commission notes, the scheme was "Ponzi-like" in nature. Although the company made money by selling phony policies to reinsurers, these profits were soon eaten up by the premium payments they had to pay the reinsurers. Thus, more insurance policies had to be created to cover the net losses on the earlier policies. (*See* SEC Br. at 3) The longer the scheme continued, the more expansive the fraud became and the more persons who were victimized.

company, its employees, its creditors, and public investors at large. The Commission lamely suggests that Secrist either could have gone to the regulatory authorities or, if they proved as ineffective as they had been in the past, sit silently while the fraud continued. (SEC Br. at 31) The Commission is thus suggesting that it is more appropriate for a corporate fiduciary to do nothing in the face of a massive crime being committed by his corporation than to seek to expose the crime through the only means he reasonably believes will be effective (and which in fact prove to be effective). This view of fiduciary duty defies rational comprehension.

Indeed, the Commission has the audacity to suggest that if the fiduciary seeks to disclose such information, with reason to believe it will be traded on, it is analogous to contracting for a profit not to report a crime. (SEC Br. at 40) Exactly the opposite is true. It is, in fact, the Commission's proposed rule, which would punish those who seek to disclose crime, while holding blameless those who remain silent, that will persuade those with knowledge of such crimes that the appropriate and personally "profitable" course of action is to keep quiet.

In the absence of any justification for its claim that Secrist breached any recognized duty, the Commission conjures up a non-existent rule of conduct for fiduciaries, and suggests that Secrist violated that rule. The Commission argues that Secrist, in making disclosure, "authorized" whatever trading subsequently took place. It contends that just as Secrist was disabled from trading on this information, he was forbidden to "authorize" such trading.[7]

The Commission suggests a blanket rule that whatever a trustee cannot do, he cannot "authorize" others to do. There is

---

[7] In fact, Secrist did not "authorize" anybody to trade, in the sense that the term is used in the Commission's cases. Secrist did expressly authorize Dirks to talk to *The Wall Street Journal*. For the rest, Secrist simply related the allegations to Dirks, and urged him to investigate and try to make them known as widely as possible, in the

no authority for such a rule and it would in fact be preposterous. Trustees commonly authorize transactions between their beneficiaries and third parties that they would be absolutely forbidden to do themselves. For example, a trustee can (and often must if a trust is to function at all) authorize the sale of trust property to third parties on fair terms, even though he himself could not buy the property, regardless of how fair the deal was. *See Restatement (Second) of Trusts* § 170, comment b (1959).

To be sure, in some circumstances a trustee's actions in "authorizing" an action by others may be improper and constitute a breach of duty. But that occurs where the trustee's action is adverse to the interests of the beneficiaries, not because he allows something he could not do himself. That was the situation, in entirely different circumstances from those presented here, in the principal cases relied on by the Commission. *See Mosser* v. *Darrow*, 341 U.S. 267, 271-72 (1951) (setting up of interest in third parties adverse to that of trust); *SEC* v. *Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971) (allowing relatives and acquaintances to trade on confidential corporate information).[8]

apparent (and well founded) belief that the SEC would never take steps to uncover the Equity Funding fraud until market conditions forced it to act. That some persons, unknown to Secrist, to whom Dirks disclosed the allegations, chose to sell their Equity Funding stock, does not mean that Secrist "authorized" those sales.

[8] Indeed, the principal holding of these cases is a remedial rule—that *where* there has been a breach of duty, a trustee will be liable for profits realized by third parties as a result of that breach. They do not stand for the proposition that all actions by a trustee which allow a third party to profit constitute a breach of duty. It was in the context of discussing this remedial rule that the Court in *Mosser* stated that a trustee cannot authorize others to do what he cannot do. 341 U.S. at 271-72. The view is that if a trustee can breach his duty, and thereby authorize others to profit, he might be able to make a covert profit which would then be unrecoverable. *Id.* The Commission takes this statement out of the remedy discussion in which it was made, and attempts to convert it into a broad and unsupportable rule of liability.

Unlike the clear breach of duty in those cases, there is no authority that would suggest that even if Secrist "authorized" the trading that took place, that his doing so for the purpose of obtaining exposure and termination of the fraud was wrongful. Indeed, it is an established rule of trust law that a fiduciary, who does not personally profit, may make hard decisions that harm the interests of a particular class or category of beneficiaries, when that action is necessary to avert a greater harm to the beneficiaries "as a whole." *See* II A. Scott, *Scott on Trusts* § 183, at 1473 (1967). Many benefits and burdens have to be allocated among different classes of trust beneficiaries, and so long as the trustee acts reasonably in the interests of all, there is no breach of duty. That is exactly what happened here.

One final point bears reflection. If, in fact, it was Secrist who was the initial wrongdoer in this case, why did the Commission not only not charge him with any wrongdoing, but fail to even mention him in its Order for Public Proceedings? (See J.A. 1-13) The answer is obvious: the theory the Commission's counsel is pursuing was cooked up for the first time before this Court, was never considered by the Commission or its staff at any time, and is plainly wrong.

4. Neither Prior Case Law Nor The Legislative History Of The Securities Laws Supports The Decisions Below

The Commission states that prior "tippee" cases established principles prohibiting trading by corporate insiders and their "tippees," suggests that this case falls within the principles enunciated in those cases, and argues that those decisions were ratified by Congress when it adopted the Securities Acts Amendments of 1975. (SEC Br. at 35-38) In fact, the principles contained in those cases are not applicable here.[9]

[9] In making this argument the Commission misstates both our position and that of the Solicitor General. The Commission states that we recognize the traditional rules against trading by insiders and their "tippees," but are seeking an "exception" to those rules. (SEC Br. at 21, 38) As the Commission is well aware, it is our view

The Commission cites *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), and several decisions arising out of the sale by insiders and their "tippees" of Douglas Aircraft Co. stock. *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974); *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 44 S.E.C. 933 (1971); *In re Investors Management Co.*, 44 S.E.C. 633 (1971).

As we discussed in our opening brief, all of those cases involved the misappropriation and conversion of confidential corporate information. (*See* Pet. Br. at 24 n.11, 27-28 n.16)[10] Those cases dealt with the misuse of inside information, and did not address the very different situation, presented in this case for the first time, where the information at issue is evidence of criminal fraud. Thus, the fact that Congress in 1975 left the holdings of these cases intact is not a basis for affirming the result here.[11]

---

that this case does not fall within the established rules. The Solicitor General expressly stated in his brief that "the disagreement between the United States and the Commission herein relates only to the *extension* of well-established legal principles to the facts of this unusual case." (Sol. Gen. Br. at 19 n.11) (emphasis in original).

[10] The Commission argues that the information in these cases could not have been corporate information capable of being misappropriated because 1) it was negative earnings information and 2) it was publicly released shortly after it was used by the insiders. (SEC Br. at 36) But the fact that the information was unfavorable did not mean that it had no corporate purpose and was not of value to the corporation. And the fact that it was publicly disclosed shortly after it was privately used did not mean that the private use, other than in accordance with the corporate disclosure schedule, was any less misappropriation. As was pointed out both in our brief and by the Solicitor General, all true "inside" information will be disclosed by the company. (Pet. Br. at 28-29; Sol. Gen. Br. at 28-29 n.24) The misappropriation lies in acting before disclosure.

[11] The Commission notes that the Congress intended to insure that "dealing in securities is fair and without undue preferences or advantages among investors." (SEC Br. at 37, *quoting* H.R. Rep. No. 229,

5. Public Policy Requires Allowing The Independent Investigation Of Criminal Fraud

The Commission claims that there are several reasons why activities such as Dirks' should be considered contrary to public policy. These arguments are without foundation, and totally fail to rebut the view of the Department of Justice—the federal agency responsible for criminal law enforcement—that penalizing the activities of analysts like Dirks will have a serious negative impact on criminal law enforcement.

(a) The Independent Investigation of Corporate Fraud Will Promote Public Disclosure Of Such Crimes

The Commission's principal policy argument is that if securities analysts are allowed to investigate independently allegations of corporate criminality, they will be less likely to make "prompt disclosure of crime to public officials." (SEC Br. at 40)

In fact, the delay between the start of Dirks' investigation and his going to the Commission staff was two weeks, during which time he repeatedly sought to have Equity Funding's auditors and *The Wall Street Journal* investigate and disclose the allegations. Even crediting this delay as of any importance (in a case the Commission staff had sat on for over a year), this

---

94th Cong., 1st Sess. 91 (1975)) The key word here is "undue." Under *Chiarella* an outsider who legally obtains non-confidential information may thereby obtain an informational advantage, but not an "undue" advantage. *See* 445 U.S. at 232. Indeed, even Justices Blackmun and Marshall, dissenting in *Chiarella*, stated after reviewing the case law in this area that an undue advantage only arises where an individual has access to information that is legally unavailable to others. *See* 445 U.S. at 249-51. As we pointed out in our opening brief (Pet. Br. at 27 n.15), and as the Solicitor General points out in his (Sol. Gen. Br. at 24-26), the information Dirks obtained was legally available to other investors willing to make the effort Dirks did. The Commission, in its brief, does not contest this. Even under the dissenters' view in *Chiarella*, undue advantages arise only when one has an opportunity "for profit from manipulation of confidential connections or resort to stealth." 445 U.S. at 252 n.2. Dirks' informational advantages arose from neither. They arose from "honest means," and were entitled to "reap their full reward." *Id.*

argument ignores the fact that if securities analysts who hear allegations of fraud are not permitted to investigate allegations of fraud, and obtain some benefit by doing so, they will not, as an alternative, spend their time ferretting out allegations to report to the regulators. Instead, they will do what the Commission's counsel has suggested was Dirks' other alternative—"nothing." (Transcript of Proceedings before Securities and Exchange Commission of June 13, 1979, at 35)

More importantly, *the Commission glosses over the fact that* the end result to be sought is not disclosure to "public officials," but action by those public officials to verify the crimes and make disclosure to the public. After all, these same "public officials" had been told of the fraud on three separate occasions over a period of years and managed to avoid uncovering any aspect of the scheme. Thus, Dirks' investigation sped the public exposure of a fraud that, in Judge Wright's words, "[t]he SEC had a history of failing to act promptly in." (Pet. App. A-9 n.6)[12] The actions of securities analysts can, as the Solicitor General and the Assistant Attorney General in charge of the Criminal Division observe, serve as a useful adjunct to the efforts of public officials in disclosing crime. (Sol. Gen. Br. at 27-28)

[12] In defense of its own record, the Commission states that the first its staff heard of the fraud was in March 1973, and that the statements that it heard the allegations in 1971 rests on a "misunderstanding." There is no misunderstanding. The record is clear that in late 1971 the Controller of Equity Funding, William Mercado, related details about the fraud, including details about phony insurance and phony confirmations of that insurance, to Morton Field, a private attorney and former SEC staff member. (J.A. 106) Field immediately contacted Rudy Reinchild, an SEC staff member at the Commission's Los Angeles office who was a "good friend" of his. (J.A. 101) He related the details of Mercado's story, including details about phony insurance and confirmations, to Reinchild. (J.A. 106-07) He subsequently related the same details to Marty Robins, another staff member at the Los Angeles office. (*Id.*) In spite of this, when Mercado was interviewed by the staff members shortly thereafter he was never questioned by them about the phony insurance allegations.

The present case is a perfect example. The record is clear that even as Dirks was making his investigation the various state regulatory agencies which were looking into the matter (as noted, the SEC once again had declined to investigate) found no evidence of fraud. (R. 7212; Dirks Ex. R, J.A. 163, 167, R. 7649, 7650) Not surprisingly, the conspirators had undertaken to conceal their wrongdoing. (Division Ex. 1, pp. 107-10, R. 159, 3877) There is nothing to suggest that, in the absence of Dirks' investigation, these efforts at concealment would not have been as successful as they had been in previous years.

The Commission would like to suggest that the fraud would have collapsed anyway. They quote in part the reorganization Trustee of Equity Funding, who concluded that the fraud avoided detection "mainly because of audacity and luck," (SEC Br. at 38 n.46), and suggest that once the regulators were aware of the allegations they necessarily would have quickly uncovered the truth. (SEC Br. at 5) What the Commission does not quote is the Trustee's conclusion that the conspirators' "luck" in concealing the fraud ran out "because of accelerating events outside the Company. Between March 19 and March 27, rumors on Wall Street of fraud at Equity Funding began to significantly affect trading in the company's stock. These rumors were based on information Secrist had given to Raymond Dirks, an insurance analyst with the New York brokerage firm of Delafield Childs, Inc." (Division Ex. 1, p. 110, R. 159, 3877).

As the trustee stated, what broke the scheme was a chain of events directly resulting from Dirks' activities. As Dirks disseminated the allegations, and as rumors of fraud spread

(J.A. 111-12) Although Mercado, believing he was in legal danger, did not volunteer any information (J.A. 114), it was surely the obligation of the staff members, having heard the allegations from a highly reliable source, to ask. Furthermore, as Mercado testified in these proceedings, Mercado later agreed to make a full disclosure if the SEC would arrange for a grant of immunity. (J.A. 112-14) The SEC staff refused to be bothered, telling Mercado's lawyer that the case was closed. (J.A. 113-14) throughout the market, there was a dramatic fall in the price of Equity Funding's stock, amid substantial trading. (J.A. 4)

This substantial trading in, and dramatic drop in the price of, Equity Funding stock forced the New York Stock Exchange (and, tagging along after the Exchange acted, the Commission) to suspend trading in the stock, even though they had no evidence that the rumors were true. (I.D. 134-35, J.A. 269-70) The Commission's staff was also forced to give the case priority, and take decisive action to either confirm or refute the rumors.[13] In contrast to their half-hearted investigation in 1971 or their casual dismissal of the story in early March 1973 (J.A. 96-98), and even though the Commission's chief enforcement officer still thought that the allegations were not firm enough to require action (Boston Co. III Ex. JJJ, p. 90, R. 8264, 8390), the Commission's staff called in the top officers of Equity Funding for questioning and requested that they "immediately furnish affidavits denying all rumors of fraud." (Dirks Ex. R, J.A. 163, 165, R. 7649, 7650)

This was the pivotal event. In response, the top conspirators retained criminal lawyers and decided to plead the fifth amendment. (R. 8112-16) Their refusal to testify was the first indication that the allegations were true. Based on that, and on the report from Illinois of missing assets, but nothing else, the California Insurance Department seized Equity Funding. (R. 7205-06) The Secretary and General Counsel of Equity Funding, who had until then believed the stories to be "vicious

[13] In addition, in response to the rumors, the honest officials of Equity Funding, led by Rodney Loeb, the company's General Counsel and Secretary, forced an internal investigation, believing that the rumors would readily be proven false. (R. 8077-82) This substantially impaired the conspirators' ability to proceed with any cover-up. For example, the first evidence of any fraud was the discovery by the Illinois Insurance Department that substantial assets of the company, supposedly in a Chicago bank, were missing. (I.D. 137, J.A. 271) The conspirators had devised a complex, but workable, plan for explaining this away (*see* Division Ex. 1, pp. 108-09, R. 159, 3877), but apparently were unable to implement it under the circumstances created by Dirks' activities.

rumors" (R. 8101-02), immediately called a special meeting of the Equity Funding Board for two days later. (R. 8121-22) At that meeting Goldblum and the other conspirators were dismissed from the company. The remaining board members agreed to the appointment of an interim manager and new auditors, and fully cooperated with the SEC in its subsequent investigation. (Division Ex. 1, p. 119, R. 159, 3877)

It is for this reason that Judge Wright concluded that "[l]argely thanks to Dirks, one of the most infamous frauds in recent memory was uncovered and exposed." (Pet. App. A-3) Indeed, even the Commission conceded that "[i]t is clear that Dirks played an important role in bringing EFCA's massive fraud to light." (Pet. App. B-26) But under the rule of law proposed by the SEC there will be no more investigations like Dirks undertook here.

(b) Allowing Investigation Of Corporate Crime Is Not Unworkable

The Commission's second policy argument is that allowing securities analysts to investigate and disclose allegations of corporate crime would impose an unworkable standard of behavior on analysts since some conduct might not clearly be criminal.[14] (SEC Br. at 42)

In fact, the standard is nothing more than a subtest of the test set forth in *Investors Management*—that a recipient of information "know or have reason to know that it was nonpublic and had been obtained *improperly* by selective revelation or otherwise." 44 S.E.C. at 641 (emphasis added). Under that standard, the recipient of information must always evaluate whether he has improperly received information or whether he was entitled to receive it.

[14] The Commission suggests, along these lines, that to allow trading on information about criminal activity would also allow trading on "information about intentionally unreported bad news that does not rise to the level of criminal activity." (SEC Br. at 42) The answer to this contention is that if a corporation is willfully failing to disclose bad news, in violation of the disclosure provisions of the securities laws, insiders are released from their obligation not to disclose such

(c) Allowing The Independent Investigation Of Corporate Crime Will Promote Market Efficiency And Confidence

The Commission's final policy contention is that allowing trading on information about criminal activity will neither improve market efficiency nor promote investor confidence. The argument as to market efficiency is in essence that the market already is highly efficient. The Commission cites a statement made in 1974 by Professor James Lorie of the University of Chicago. While Professor Lorie has indeed praised the existing efficiency of the securities markets, he has since also stated, in discussing this case, that "[t]he main improvements in the system of disclosure" will come from the private initiative of analysts like Dirks. Lorie, *Insider Trading: Rule 10b-5, Disclosure, and Corporate Privacy: a Comment*, 9 J. Leg. Stud. 819, 822 (1980). As we have noted in our principal brief, Professor Lorie is of the view that Dirks' activities deserve high praise, not punishment. *Id.* Moreover, the SEC insists that analysts rarely obtain information about corporate fraud, so that the revelation of such crimes would be minimal and would not greatly affect overall market efficiency. Even if that were so, it hardly supports a policy of discouraging persons from uncovering whatever fraud does exist.

Furthermore, confidence in the securities markets will be substantially enhanced if the investing public knows that there are even a few securities analysts seeking to ferret out corporate fraud, operating as a check on those analysts who principally rely on information disseminated by the company, and also serving as a deterrent to those who would consider perpetrating such fraud.[15]

---

information. Indeed, dissemination of the information to the market may be the only way to make effective disclosure. The mandatory disclosure obligations of the securities laws would have little meaning if corporate officials could be forced to keep information required to be disclosed a secret or be charged with a breach of fiduciary duty.

[15] The Commission contends, again quoting Professor Lorie's 1974 statement, that investor confidence would be diminished since the investigation and disclosure of crime by securities analysts would favor large institutional investors, who generally have better access to such analysts than small investors. (SEC Br. at 44 n.59) Of course, many of these institutional investors, such as pension funds and mutual funds, are really amalgamations of small investors. Furthermore, to the extent the individual small investor is disadvantaged, this is, as Professor Lorie notes, an existing structural problem, and would be the same with respect to any legally derived information gathered by an analyst. That it would be true with respect to this information as well does not render the use of this information by analysts any more "unfair" than their everyday activities already are.

6. The Allegations Heard By Dirks Were Not "Facts" Subject To Disclosure Obligations Under The Federal Securities Laws

The Commission fails to deal with the fact that the stories heard by Dirks were not "facts" subject to disclosure obligations under the antifraud provisions of the federal securities laws, but rather were unverified allegations.[16] The clearest evidence of this, which the Commission does not contest, is that even after hearing everything which Dirks had to say, neither the SEC nor the New York Stock Exchange believed that they had anything but unverified allegations, on which they could not act, and *The Wall Street Journal* did not believe that they could publish a story based on the allegations. (Pet. Br. at 41-42). In fact, the head of the SEC's Enforcement Division testified to this effect before Congress. (Boston Co. III Ex. JJJ, p. 90, R. 8264, 8390) In spite of the fact that these responsible regulators, and a responsible newspaper, did not believe that the information was something they could act on,

---

[16] The Commission concentrates entirely on the question of whether these allegations were considered important by some investors, and thus were in some sense "material." This is a totally separate issue. Even a bare rumor, if shocking enough, may be considered important by a reasonable investor even if there is only a small chance that it is true. But such rumors have never been considered to be "facts" which must be disclosed in the course of trading. *See, e.g., SEC v. Monarch Fund*, 608 F.2d 938 (2d Cir. 1979); *Hassig v. Pearson*, 565 F.2d 644 (10th Cir. 1977); *Ruszkowski v. Hugh Johnson & Co., Inc.*, 302 F. Supp. 1371 (W.D.N.Y. 1969).

the Commission contends that the stories were "reliable" enough for Dirks to be required to disclose them.

As we have discussed in our opening brief, treating such unverified (and possibly false) allegations as "fact" will force analysts who hear such rumors to "act at their peril," *SEC* v. *Monarch Fund*, 608 F.2d 936, 943 (2d Cir. 1979), since they will not be in a position to obtain public disclosure of the stories[17] and cannot be sure that the stories will ever be confirmed or refuted. The only appropriate way to treat such rumors is to allow the analyst to investigate them, seek out information about them from others in the investment community, and attempt to either confirm them or refute them. That is what Dirks did, and it is an eminently proper course of conduct.

CONCLUSION

For the foregoing reasons, and for the reasons stated in our opening brief and that of the Solicitor General of the United States, the decision of the Court of Appeals should be reversed.

Respectfully submitted,

DAVID BONDERMAN
Counsel of Record
LAWRENCE A. SCHNEIDER
ERIC SUMMERGRAD

ARNOLD & PORTER
1200 New Hampshire Ave., N.W.
Washington, D.C. 20036
(202) 872-6700
Attorneys for Petitioner Raymond L. Dirks

March 1983

---

[17] As we observed in our opening brief, Dirks in fact did everything that was in his power to obtain public disclosure of the fraud. (*See* Pet. Br. at 17)