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## Dirks and the Genesis of Personal Benefit

Adam C. Pritchard  
*University of Michigan Law School*

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# DIRKS AND THE GENESIS OF PERSONAL BENEFIT

A.C. Pritchard\*

## ABSTRACT

*In United States v. Newman, the Second Circuit overturned the insider trading convictions of two hedge fund managers who received material nonpublic information from public companies via an extended tipping chain. The Newman court interpreted the Supreme Court's decision in Dirks v. SEC as requiring that the government prove: (1) that the tippee knew that the tipper was disclosing the information in exchange for a personal benefit; and (2) that if the personal benefit does not involve a quid pro quo to the tipper, that the disclosure arise from a "meaningfully close personal relationship" with the recipient of the information. The U.S. Attorney and the SEC reacted sharply to Newman, decrying it as a departure from Dirks. This essay traces the "judicial history" of Dirks' personal benefit requirement. Based on that history, I conclude that Newman's knowledge standard is the correct reading of Dirks and that its requirement of a "meaningfully close personal relationship" is consistent with, if not compelled by, the rule laid down in Dirks.*

## I. INTRODUCTION

**U**NITED States v. Newman<sup>1</sup> is the most important insider trading opinion since the Supreme Court upheld the misappropriation theory in *United States v. O'Hagan*.<sup>2</sup> In *Newman*, the Second Circuit grappled with the elements required for a criminal insider trading violation. The defendants in *Newman* were tippees who received material non-public information from a chain of informants that ultimately led to an insider.

The last word from the Supreme Court in the area of tipper-tippee liability is *Dirks v. SEC*, handed down in 1983.<sup>3</sup> The *Dirks* court, in an opinion written by Justice Lewis F. Powell, Jr., held that there was no

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\* Frances and George Skestos Professor of Law, University of Michigan. I benefited from comments by Don Langevoort. I wish to acknowledge the generous support of the William W. Cook Endowment of the University of Michigan.

1. 773 F.3d 438 (2d Cir. 2014), *cert. denied*, \_\_\_ S. Ct. \_\_\_, 2015 WL 4575840.  
2. 521 U.S. 642 (1997).  
3. 463 U.S. 646 (1983).

violation of Rule 10b-5 of the Exchange Act<sup>4</sup> absent a breach of fiduciary duty by the insider-tipper in providing the information. A breach of fiduciary duty, according to *Dirks*, required that the tipper receive “a monetary or personal benefit for revealing [corporate] secrets” or have the “purpose to make a gift of valuable information.”<sup>5</sup> Either would satisfy the *Dirks* test: “whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders.”<sup>6</sup> Absent a “direct or indirect personal benefit from the disclosure,” there could be no deception and, therefore, no fraud under Rule 10b-5.<sup>7</sup>

The *Newman* court was required to interpret *Dirks*' personal benefit standard in order to answer the question: what must tippees know about the disclosure of non-public information by the tipping corporate insider in order to sustain a conviction? The *Newman* court rejected the government's argument—based on the Second Circuit's prior decision in *SEC v. Obus*<sup>8</sup>—that it was sufficient that the tippee know that the information has been revealed by the tipper in breach of a duty of confidentiality. Instead, the *Newman* court held that “in order to sustain a conviction for insider trading, the [g]overnment must prove beyond a reasonable doubt that the tippee knew that an insider disclosed confidential information *and* that he did so in exchange for a personal benefit.”<sup>9</sup> The court further held that the government must prove that the personal benefit to the tipping insider involved “a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature. . . . [T]his requires evidence of ‘a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the [latter].’”<sup>10</sup>

The government's reaction to the *Newman* opinion was sharp, arguing in its petition for rehearing that the decision was “flatly inconsistent with *Dirks*” and that “its erroneous redefinition of the personal benefit requirement will dramatically limit the government's ability to prosecute some of the most common, culpable, and market-threatening forms of insider trading.”<sup>11</sup> The Securities and Exchange Commission (SEC) chimed in with an amicus brief asserting that the decision was “directly at odds” with *Dirks* and prior Second Circuit precedent.<sup>12</sup> The Second Cir-

4. 17 C.F.R. § 240.10b-5.

5. *Dirks*, 463 U.S. at 667.

6. *Id.* at 662.

7. *Id.* at 667 n.27.

8. 693 F.3d 276 (2d Cir. 2012).

9. *United States v. Newman*, 773 F.3d 438, 450 (2d Cir. 2014).

10. *Id.* at 452 (quoting *United States v. Jiau*, 734 F.3d 147, 153 (2d Cir. 2013)).

11. Petition of the United States of America for Rehearing and Rehearing *En Banc*, *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014) (No. 13-1837(L)), 2015 WL 1064423, at \*13, \*3 (Jan. 23, 2015).

12. Brief for the Securities and Exchange Commission as Amicus Curiae Supporting the Petition of the United States of America for Rehearing and Rehearing *En Banc*,

cuit stood its ground, denying the motion for rehearing.

This Essay traces the genesis of the personal benefit test in *Dirks*. The outcome of *Dirks*—an “easy case”—was never in doubt, but the standard for tipper-tippee liability was nonetheless labored over by Justice Powell and his clerk. Their goal was to find a clear principle to govern subsequent cases. The path that Powell took to overturning the SEC’s sanction in *Dirks* sheds light on the personal benefit issue faced by the *Newman* court.<sup>13</sup> I conclude that this “judicial history” is consistent with the *Newman* Court’s interpretation of the *Dirks* personal benefit test. Liability under Rule 10b-5 requires the government to prove: (1) that the tipper disclosed material non-public information for the purpose of acquiring an indirect personal benefit by making a gift to the recipient, which requires a relationship of some substance; and (2) that both the tipper and tippee acted with scienter in breaching their duties.

## II. DIRKS AND PERSONAL BENEFIT

The SEC censured Dirks, a securities analyst employed by a broker-dealer, in an administrative proceeding.<sup>14</sup> Dirks informed his clients about a massive fraud at Equity Funding that he learned of by interviewing current and former Equity Funding employees. Dirks’ customers relied on that information to sell Equity Funding shares before the company’s collapse.<sup>15</sup> According to the SEC, Dirks aided and abetted his customer’s violation of Rule 10b-5 of the Exchange Act.

The Supreme Court ultimately rejected the SEC’s conclusion that Dirks’ conduct violated Rule 10b-5. How did the Court reach that conclusion? Justice Powell, who considered himself the Supreme Court’s leader in securities law, prepared a memorandum for the conference at which the justices would decide *Dirks*.<sup>16</sup> Powell’s theory for the anti-tipping standard turned on the tipper’s purpose in disclosing the non-public information: Was that purpose consistent with the insider’s fiduciary duty? Powell explained to his colleagues:

We made an important point in *Chiarella* [*v. United States*].<sup>17</sup> It did not involve a tippee, but it did establish that liability cannot be imposed in the absence of a fiduciary duty to disclose before trading.

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United States v. Newman, 773 F.3d 438 (2d Cir. 2014) (No. 13-1837(L)), at 2–3 (January 2015).

13. Portions of this section draw from my prior account of Justice Powell’s influence on securities law, *Justice Lewis F. Powell, Jr. and the Counter-Revolution in the Federal Securities Laws*, 52 DUKE L.J. 841 (2003), but I have supplemented that account to focus on the materials from Justice Powell’s *Dirks* file relevant to *Newman*. The unpublished materials from that file cited here are available at the law library of the Washington & Lee University.

14. *In re Raymond L. Dirks*, Exchange Act Release No. 17,480, 21 SEC Docket 1401, 1412–13 (Jan. 22, 1981).

15. *Id.* at 1405.

16. Justice Lewis F. Powell, Jr., Memorandum for Conference, *Dirks v. SEC* 1 (Mar. 23, 1983).

17. 445 U.S. 222 (1980) (Powell, J.).

The only reference in *Chiarella* to tippees is in footnote 12. The critical sentence in this note says:

“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.”

Thus, where the tippee becomes a “participant after the fact,” he shares whatever duty the insider breached by conveying the information. This analysis makes Dirks’ case easy to decide. His liability depends on a finding that the former Equity Funding employees—of which *Secrist* [Dirks’ principal source] was only one—who disclosed the fraud, breached their fiduciary duty to Equity Funding.

But even the SEC concedes there was no such breach of duty. None of these employees profited by disclosing fraud. They acted strictly in the public interest. Therefore, Dirks was not a participant after the fact in anyone’s breach of duty.<sup>18</sup>

*Chiarella* required a breach of duty; Dirks’ sources had violated no duty. Dirks therefore could not be liable for violating Rule 10b-5.

Powell was not satisfied, however, with merely exonerating Dirks. He continued:

Deciding this case without identifying a general principle would accomplish very little.

Let me make clear the type of situation to which the principle would be applied. This case does not involve a *Texas Gulf Sulfur* situation<sup>19</sup> where an officer or director of a corporation himself trades on inside information for personal gain. Nor do we have an insider—who to benefit a friend—discloses inside information on which the friend profits. The law is fairly well settled with respect to these straightforward cases.

The much broader, underlying problem in this case concerns the necessity of information being made available for the health of the securities markets. In this case, the SEC’s opinion stated:

“In the course of their work, analysts actively seek out bits and pieces of corporate information not generally known to the market for the express purpose of analyzing that information and informing their clients who, in turn, can be expected trade on the basis of the information. The value to the entire market of these efforts cannot be gainsaid: market efficiency in practice is significantly enhanced by such initiatives to ferret out an[d] analyze information, and thus the analysts’ works redowns [sic] to the benefit of the investors.”

If we sustain its opinion in this case securities analysts will be far less liable to “ferret out” information. They will be concerned constantly

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18. Justice Lewis F. Powell, Jr., Memorandum for Conference, *Dirks v. SEC*, *supra* note 16, at 1.

19. *SEC v. Tex. Gulf Sulphur Co.* 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

with the uncertainty of lawsuits, with juries determining whether the information circulated was confidential and should not have been disclosed.<sup>20</sup>

Breach of a duty of confidentiality was clearly insufficient to allege an insider trading violation, in Powell's view. Powell proposed an alternative principle: "[a] tippee's liability should depend on the *purpose or intent* of the insider's disclosure." Powell conceded that this was "a subjective rule," but one he defended as "principled and practical."<sup>21</sup> Powell recognized that the "question of 'purpose' (intent) will be determined—as it is so often in the law—by the facts." The relevant facts would include

(i) The relationship between the insider and the recipient (e.g., the analyst); what were their respective purposes? Particularly, did the insider expect to profit himself or to benefit a friend rather than to inform the market generally?

(ii) Who initiated the disclosure? Typically, the analyst seeks out the corporate executive—this is commonplace. Equally commonplace, executives brief large meeting of analysts. The circumstances of the disclosure are relevant—as in this case.<sup>22</sup>

Powell wanted to leave space for securities professionals to uncover non-public information, even if it came from corporate insiders. Not having a ban on tipping was a non-starter for Powell; insiders would trade information for cash or give it to the stereotypical golfing buddy. On the other hand, the SEC could not be trusted to determine the boundaries of legitimate and illegitimate use of inside information. Leaving it to the agency to draw the line would lead to analysts being completely frozen out.

Powell was able to swing a majority to reverse the SEC, but holding a court would be a challenge as no consensus rationale emerged from the conference.<sup>23</sup> The risk that the *Dirks* majority would fragment was real. Powell and his law clerk, James Browning, got to work. Browning wrote to his boss:

We both know *Dirks* is a freak case. The situations we are concerned with are where securities analysts interview employees seeking information: is there liability? If the breach of an employee's duty alone is enough to establish tippee liability, securities analyst [sic] will be chilled from using any of the information he gets. If, on the other hand, exploitation of confidential information by insiders is a prereq-

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20. Justice Lewis F. Powell, Jr., Memorandum for Conference, *Dirks v. SEC*, *supra* note 16, at 2–3.

21. *Id.* at 4.

22. *Id.*

23. Justice White's vote, for example, was "tentative," and seemed to be based on the fact that *Dirks* "didn't unload," although Justice White thought that "[h]is tippees may be guilty of violating rules." Handwritten notes of Justice Lewis F. Powell, Jr., from the Conference on *Dirks v. SEC* 1 (Mar. 23, 1983). Justice Stevens, by contrast, thought that "*Dirks* breached no duty. Even if he had owned stock + sold it, but [sic] he had no duty. A person who is an outsider has no duty." *Id.* at 3. Justice O'Connor thought that "the ultimate solution is to require fraud to be disclosed first to SEC—would like to say this." *Id.*

uisite to tippee liability, securities analysts will be encouraged to seek information from corporate employees. I will not emphasize the obvious benefits of protecting the information-gathering duties of a securities analyst.<sup>24</sup>

Powell agreed that “*Dirks* is easy, but is there a general principle?”<sup>25</sup> He wanted to protect analysts in their work without inviting “exploitation” by insiders.

Browning’s first draft, as edited by Powell, formulated this test for tipping liability:

It is first necessary, in order to make out a tipping case against an insider, to prove that the insider exploited confidential information in violation of his fiduciary duties to shareholders. Whether disclosure of material nonpublic information is a breach of duty thus depends on the purpose of the disclosure. The tipper will be liable if (i) he discloses material, nonpublic information to one who trades on the information and (ii) the purpose of the disclosure was to receive some benefit in return or to make a gift of the information to the recipient to enable him to gain a market advantage over other traders. Similarly, a 10b-5 claim against an alleged tippee must be based on the theory that he knowingly participated with the insider in exploiting the confidential information: in essence that he was an aider and a better [sic]. A recipient of such a tip would be liable if used the information in connection with securities trading, knowing the purpose of the disclosure.<sup>26</sup>

Two things jump out from this passage: (1) the insider must be tipping for the purpose of making a gift; and (2) the tippee must *know* that this was the insider’s purpose. Indeed, Powell instructed Browning to omit a reference to the SEC’s position that the “tippee need not have *actual* knowledge of a breach of duty of the tipper.”<sup>27</sup> Powell did not “wish to encourage the Commission to infer knowledge or claim constructive knowledge on suspicion.”<sup>28</sup> If the *Dirks* opinion had gone to print at this point, *Newman* would have been an uncontroversial application of *Dirks*.

Browning’s second draft restated this test with no material changes,<sup>29</sup> but the test subsequently began to evolve. Powell wrote a rider for insertion into the draft opinion, laying out what he saw as the correct analytical framework. The rider notes that “tippee [sic] must have had ‘notice of the violation of duty.’”<sup>30</sup> In the accompanying *Note to Jim and Myself*,

24. Memorandum from Jim [Browning] to Justice Lewis F. Powell, Jr. 6-7 (Mar. 22, 1983).

25. *Id.* (handwritten notes of Justice Lewis F. Powell, Jr.).

26. FIRST DRAFT: *Dirks v. SEC*, No. 82-276 (April 30, 1983), at 24-25 (footnotes omitted).

27. Memo from Lewis F. Powell, Jr. to Jim [Browning], 82-276 *Dirks v. SEC*, at 5 (May 2, 1983).

28. *Id.* at 6.

29. SECOND DRAFT: *Dirks v. SEC*, No. 82-276 (May 10, 1983), at 20-21 (footnotes omitted).

30. Rider A, at 14 (*Dirks*) (05/14/83) (quoting 3 LOUIS LOSS, SECURITIES REGULATION 1451 (1961)).

Powell confessed to struggling with the issue. Seclist had breached no duty, which meant that Dirks would be off the hook, but Powell's ambition for the opinion was broader:

We would like, in addition, to make clear that the typical situation in which this question may arise is where analysts – in the normal course of their work – obtain and use confidential information. Determining whether the tipper has breached a duty and whether the tpee [sic] had notice, present two difficult questions. The standard we propose with respect to the tipper is his purpose or motive – essentially a subjective standard. It will be even more difficult to show whether or not the tpee [sic] had notice of an improper motive. These are the questions that make this case so difficult.<sup>31</sup>

In a handwritten note in the margin of the memo, commenting on the appropriate standard of liability, Powell wrote: "I'm not sure the 'scienter' test is applicable. I'll re-read *Ernst & Ernst*."<sup>32</sup> In a separate rider, Powell grappled with the question of scienter.

It is clear under our Rule 10b-5 cases that liability is imposed only when one acts with scienter (cite cases). There would be no breach of duty where corporate executive [sic] inadvertently or even negligently disclosed the information relied upon. The critical question, therefore is whether there was an intent or purpose to disclose material nonpublic information to one who could trade on the information to the detriment of shareholders. Ascertaining intention may be difficult, but this is a familiar question often confronted by courts. There are facts and circumstances that often justify inferences of wrongful purpose. For example there may be a relationship exists [sic] the insider and [sic] the recipient that a *quid pro quo* from the latter, or an intention to benefit the recipient. Also, such inference may arise where the disclosure was made at the initiative of the insider rather than by the recipient tpee [sic].

Where a breach of fiduciary duty by the insider is established, liability may be imposed on the tpee [sic] only when he has notice of such a breach. See *supra*, at \_\_. Again, this is a question of fact that must be resolved in light of all relevant circumstances. A securities analyst, making a study of a particular corporation that includes interviews with its officers, acquires information that may form the basis of a market letter to clients. This is a typical situation, and customarily involves participants who understand their responsibilities and adhere to them. But there are cases, of course where the facts – and inferences reasonable [sic] drawn from them – demonstrate the requisite scienter on the part of both the tipper and the tpee [sic]. This is not such a case.<sup>33</sup>

The element of scienter is present here, but in this version of the test it is not entirely clear how that element maps on to Powell's theory of breach

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31. *Id.* at 2–3.

32. *Id.* at 2.

33. *Dirks* Memo from Lewis F. Powell, Jr. (May 14, 1983).



of duty. Powell's earlier formulation suggested that the tipping test was about duty, not state of mind, although motive was relevant to duty. In this rider, the line between the two elements has been blurred.<sup>34</sup>

After Powell's additions, Browning generated a fourth draft with this formulation of the critical standard: "A tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider breaches his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows of the breach."<sup>35</sup> The fourth draft also contains Powell's "*quid pro quo*" and "intention to benefit the recipient" language from the rider quoted above.<sup>36</sup>

After receiving the first printed draft of the opinion, Powell added a new rider that explored the element of the tipper's purpose in greater detail:

There may be situations where both the insider and the analyst recipient have acted in good faith, and yet release of the information affected markets. Whether disclosure is a breach of duty therefore depends in large 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 – e.g., a corporate official mistakenly thinks the information already has been disclosed or that it is not material enough to affect the market. And absent a breach by the insider, there is no derivative breach.<sup>37</sup>

Disclosure of material information is clearly insufficient, and improper purpose is still the touchstone. Powell muddies the waters, however, by offering an example for which scienter would clearly be lacking. Has the fiduciary duty not been breached, or is scienter lacking? Or both?

A subsequent change deepens the mystery. The first printed draft carries over the "tippee knows of the breach" phrasing quoted from Browning's fourth draft above.<sup>38</sup> The second printed draft, however, broadens the standard: "The tippee knows or should know that there has been a breach."<sup>39</sup> The "knows or should know" language is repeated two pages later.<sup>40</sup> The changes are not reflected in Powell's handwritten notes on the first printed draft, nor are they included in one of his riders. More puzzling, the memos cited above suggest that Powell favored the requirement that the tippee have actual knowledge of the tipper's breach. The change does make the language in the text more consistent, however, with the authorities cited in the appended footnote, as well as with the

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34. Powell wrote an additional rider, discussing the effect that the SEC's theory would have on the work of analysts. Rider A, at 26 (*Dirks*) (May 14, 1983). This rider found its way into the published opinion largely intact. See *Dirks*, 463 U.S. at 658–59.

35. FOURTH DRAFT: *Dirks v. SEC*, No. 82-276 (May 20, 1983), at 19–20 (footnote omitted).

36. *Id.* at 23.

37. Rider A, at 15 (*Dirks*) (May 23, 1983).

38. CHAMBERS DRAFT, *Dirks v. SEC*, No. 82-276, at 13 (May 22, 1983).

39. CHAMBERS DRAFT II, *Dirks v. SEC*, No. 82-276, at 13 (May 25, 1983).

40. *Id.* at 15.

SEC's prior position.<sup>41</sup> Browning's recollection—more than thirty years after the fact—was that the change was made to make the opinion more consistent with those authorities as well as the concurring opinion of Commissioner Smith in *In re Investors Management Co.*,<sup>42</sup> an SEC insider trading decision heavily relied upon in the *Dirks* opinion.<sup>43</sup> There had also been discussion in Powell's chambers of hypothetical tippees—waiters and taxicab drivers who overheard material, non-public information being discussed by corporate insiders—and the proper standard to be applied to their state of mind. The change was not, however, intended to depart from the established standard of scienter for Rule 10b-5 violations, which was taken as a given.<sup>44</sup> The distinction was not important to the decision of the case because the Court concluded that Sechrist had not breached a duty in providing the information to Dirks, so Dirks' knowledge was irrelevant. Nonetheless, this addition would be seized upon by the SEC—with significant consequences for the law of insider trading in the Second Circuit—later on.<sup>45</sup>

Powell's emphasis on "purpose" in determining whether there was a fiduciary breach proved to be the critical stumbling block in the quest for a majority. Powell quickly got three votes for his initial circulation (Justices White, Rehnquist, and Stevens).<sup>46</sup> Justice O'Connor, however, worried that looking to the insider's improper purpose in disclosing the information would require:

[T]he fact-finder . . . to determine the subjective state of mind of the insider, and liability may be imposed only when the insider has an improper purpose, or the tippee has some independent duty not to trade. Although there may be rules of thumb, *e.g.*, the one you suggest concerning relationship between the parties, that are used to help determine subjective intent, it nevertheless appears that the focus of the inquiry is subjective motivation. Your focus on subjective purpose is consistent with, and very much like, your approach in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), although that opinion is not cited in your draft.<sup>47</sup>

O'Connor found this "an inherently difficult determination to make. It requires that the tippee 'predict' what is going on in the mind of his tipper."<sup>48</sup> O'Connor contrasted the materiality determination, which she thought manageable for the tippee, with the tippee's ability to assess

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41. The footnote made it into the published opinion unchanged. See *Dirks*, 463 U.S. at 660 n.20.

42. 44 S.E.C. 633 (1971).

43. Telephone Interview with James Browning (May 22, 2015).

44. *Id.*

45. See text at *infra* notes 63–88.

46. Letter from Justice Lewis F. Powell to Justice Byron R. White et al. 1 (June 9, 1983).

47. Letter from Justice Sandra Day O'Connor to Justice Lewis F. Powell, Jr. 2 (June 7, 1983).

48. *Id.*

“whether an insider subjectively possesses a prohibited purpose.”<sup>49</sup> O’Connor also worried that “the purpose test might prohibit the dissemination of the information in this case. If Seclist’s motivation was proven to be a desire for vengeance [sic] against Equity Funding, and if the SEC determined that this was a prohibited purpose, Seclist and Dirks would violate the securities laws.”<sup>50</sup> Powell disagreed.<sup>51</sup> O’Connor suggested that: “[T]he ‘purpose’ discussion may be omitted without altering your basic approach.”<sup>52</sup> Powell also disagreed with this point.<sup>53</sup> O’Connor’s alternative nonetheless appealed to Powell:

[W]hether the insider derives a direct or indirect benefit from his disclosure, and that benefit is primarily of a pecuniary nature. An emphasis on benefit differs from your approach only insofar as it establishes a more objective indicia of liability. If, as a factual matter, the insider did not benefit from his disclosure, then I am not inclined to be concerned with a further inquiry into his motivation. I am not sure about what will be gained from an inquiry into intent, but from my past experience on the bench, I know that a great deal of time will be lost!<sup>54</sup>

Without a personal benefit, purpose would be irrelevant, according to Justice O’Connor, streamlining the inquiry.

Powell incorporated O’Connor’s “quite constructive” suggestion into his standard.<sup>55</sup> Powell made the following changes to accommodate O’Connor’s personal benefit criterion:

- Before: both the insider and the analyst will act in good faith  
 After: the insider will act consistently with his fiduciary duty to shareholders
- Before: Whether disclosure is a breach of duty therefore depends in large 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.  
 After: Whether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure, *i.e.*, whether the insider personally expects to benefit, directly or indirectly, from his disclosure. Absent such purpose, there has been no breach of duty to stockholders.

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49. *Id.* Powell noted his agreement with this statement in the margin. *Id.* (“I agree”) (handwritten notes of Justice Lewis F. Powell, Jr.).

50. *Id.*

51. *Id.* (“No”) (handwritten notes of Justice Lewis F. Powell, Jr.).

52. *Id.*

53. *Id.* (“No”) (handwritten notes of Justice Lewis F. Powell, Jr.).

54. *Id.*

55. Letter from Justice Lewis F. Powell, Jr., to Justice Sandra Day O’Connor 1 (June 9, 1983).

- Added: The SEC argues that, if inside-trading liability does not exist when the information is transmitted for a proper purpose but is used for trading, it would be a rare situation when the parties could not fabricate some ostensibly legitimate business justification for transmitting the information. We think the SEC is unduly concerned. In determining whether the insider's purpose in making a particular disclosure is fraudulent, the SEC and the courts are not required to read the parties' minds. *Scienter* may be relevant in some case in determining whether the tipper has violated his *Cady, Roberts* duty, but to determine whether the disclosure itself "deceive[s], manipulate[s], or defraud[s]" shareholders, *Aaron v. SEC*, 446 U.S. 680 (1980), courts should focus on whether the insider expects to receive a direct or indirect personal benefit from the disclosure, such as—for example—a pecuniary gain or a reputational benefit that may translate into future earnings.
- Before: Determining the purpose of any one disclosure, a question of fact, will not always be easy for the courts.
- After: Determining whether an insider personally benefits from a particular disclosure, a question of fact, will not always be easy for courts.
- Before: The tippers received no monetary or personal benefit for revealing Equity Funding's secrets, nor did they have any apparent purpose or desire to make a gift of valuable information to Dirks.
- After: The tippers received no monetary or personal benefit for revealing Equity Funding's secrets, nor was their purpose to make a gift of valuable information to Dirks.<sup>56</sup>

These changes narrowed the scope of improper purposes that the SEC could argue constituted breaches of fiduciary duty under Rule 10b-5; "good faith" was purged. O'Connor's personal benefit standard made clear that garden variety breaches of the duty of care were clearly out, including breaches of the duty of confidentiality. As a result, the federal common law of insider trading was aligned with the traditional distinction in state corporate law between breaches of care and loyalty; tipping required a breach of the duty of loyalty.<sup>57</sup>

In adding the personal benefit requirement, Powell did not eliminate the requirement that the SEC prove the tipper's *purpose* in disclosing; his revisions simply narrowed the test to require that the purpose be to gain a personal benefit by disclosing the information. Moreover, these additions clarify that the personal benefit requirement is distinct from the question

56. Compare Justice Lewis F. Powell, Jr., First Draft Opinion, *Dirks v. SEC* 14–15, 18–19 (May 28, 1983), with Justice Lewis F. Powell, Jr., Second Draft Opinion, *Dirks v. SEC* 14–15, 18–19 (June 9, 1983).

57. See also *Dirks*, 463 U.S. at 653 n.10 (distinguishing "the duty that insiders owe to the corporation's shareholders not to trade on inside information . . . from the common-law duty that officers and directors also have to the corporation itself not to mismanage corporate assets, of which confidential information is one").

of scienter. The personal benefit test goes to the question of duty, not state of mind, as evidenced by the reference to scienter in the longest addition. This distinction perhaps sheds light on the prior shift to “knows or should know” highlighted above; “should know” is sufficient to demonstrate participation in a breach of duty by the insider. The government, however, must also show the tippee’s scienter—an intent to defraud—to satisfy the elements of Rule 10b-5.

O’Connor’s change created a more predictable framework—and a narrower prohibition—to achieve Powell’s ultimate goal of protecting the analyst community from being swamped by the prohibition against insider trading. Powell, perhaps suspecting that the SEC would endeavor to do an end run around the personal benefit requirement, retained the purpose requirement as well. Sending the revised draft to Justices White, Rehnquist, and Stevens, he assured them that “[t]he reasoning of the opinion is not changed. Sandra thought my reference to the ‘purpose’ of the insider was unnecessarily subjective. She prefers using the more objective term: ‘benefit’ to insider, direct or indirect.”<sup>58</sup>

The last set of changes to Powell’s opinion came in response to Justice Harry Blackmun’s dissent. Blackmun raised the issue of scienter:

Of course, an insider is not liable in a Rule 10b-5 administrative action unless he has the requisite scienter. *Aaron v. SEC*, 446 U.S. 680, 691 (1980). He must know or intend that his conduct violate his duty. Secrist obviously knew and intended that Dirks would cause trading on the inside information and that Equity Funding shareholders would be harmed. The scienter requirement addresses the intent necessary to support liability; it does not address the motives behind the intent.<sup>59</sup>

Blackmun’s conflation of motive and scienter prodded Powell to clarify the role of scienter in his opinion, emphasizing that scienter and duty were separate issues. Motive was principally relevant to the latter.

Scienter in some cases is relevant in determining whether the tipper has violated his *Cady, Roberts* duty. But to determine whether the disclosure itself “deceive[s], manipulates[s], or defraud[s]” shareholders, *Aaron v. SEC*, 446 U.S. 680, 686 (1980), the initial inquiry is whether there has been a breach of duty by the insider. This requires courts to focus on objective criteria, *i.e.*, whether the insider receives a direct or indirect personal benefit from the disclosure, such a pecuniary gain or a reputational benefit that will translate into future

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58. Letter from Lewis F. Powell, Jr. to Justices White, Rehnquist, and Stevens, re: 82-276 *Dirks v. SEC* (June 9, 1983) (citations omitted).

59. Harry A. Blackmun, Xerox Copy of Dissenting Opinion, *No. 82-276 - Dirks v. SEC*, at 8 n.10 (June 24, 1983). Justice Blackmun also suggested that “When the disclosure is to an investment banker or some other adviser, however, there is normally no breach because the insider does not have scienter: he does not intend that the inside information be used for trading purposes to the disadvantage of shareholders.” *Id.* at 8 n.11. This suggestion provoked a dismissive “naïve” from Powell in the margin of Powell’s copy of Blackmun’s dissent, and a note that it was “Contradictory!” of what Blackmun had said in the passage quoted in the text. *Id.* at 8 (handwritten notes).

earnings.<sup>60</sup>

Deception was the element of Rule 10b-5 to be decided in *Dirks*, not state of mind, and without a breach of duty, there could be no deception. Powell appended a footnote to this passage further sharpening the distinction.

*Scienter* — “a mental state embracing intent to deceive, manipulate, or defraud”—is an independent element of a Rule 10b-5 violation. Contrary to the dissent’s suggestion, motivation is not irrelevant to the issue of *scienter*. It is not enough that an insider’s conduct results in harm to investors; rather, a violation may be found only where there is “intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.” The issue in this case, however, is not whether Secrist or Dirks acted with *scienter*, but rather whether there was any deceptive or fraudulent conduct at all, *i.e.*, whether Secrist’s disclosure constituted a breach of his fiduciary duty and thereby caused injury to shareholders. Only if there was such a breach did Dirks, a tippee, acquire a fiduciary duty to disclose or abstain.<sup>61</sup>

*Scienter* might be relevant in future cases that the SEC might bring, but Secrist lacked an improper motive—*i.e.*, the desire to gain a personal benefit—which meant that there was no breach of fiduciary duty, and, hence, no deception. Therefore, the Court had no occasion to inquire into either Secrist’s or Dirks’ state of mind.<sup>62</sup> In a future case, *scienter* might be a dispositive issue, and motive might be relevant to *scienter*, but the prior question was deception. That question turned on whether the disclosure was made with an improper motive, *i.e.*, in exchange for a personal benefit, direct or indirect. The opinion was handed down the following week.

### III. *OBUS*

The SEC was not happy with the constraints imposed on it by *Dirks*, and the agency worked hard to loosen those fetters. The agency initially sought to expand the definition of reputational benefit in ways that cannot be squared with *Dirks*.<sup>63</sup> The most conspicuous shot across the bow came in 2000, however, when the SEC adopted Regulation FD, which prohibits selective disclosures of the sort that Powell sought to protect with his personal benefit test in *Dirks*.<sup>64</sup> Regulation FD limits selective

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60. THIRD DRAFT, *Dirks v. SEC*, No. 82-276, at 17 (June 27, 1983).

61. *Id.* at 17 n.23 (citations omitted).

62. Another addition to this draft emphasizes that deception is a separate element. *Id.* at 20 n.27 (“Moreover, to constitute a violation of Rule 10b-5, there must be fraud. There is no evidence that Secrist’s disclosure was intended to or did in fact ‘deceive or defraud’ anyone.”) (citation omitted).

63. *SEC v. Stevens*, No. 1:91-CV-01869-CSH (S.D.N.Y. Mar. 19, 1991) (SEC secured a settlement against a tipper when a CEO allegedly provided material nonpublic information to an investment analyst with the “hope” that the analyst would issue favorable reports about the CEO’s company in the future).

64. Selective Disclosure and Insider Trading, Securities Act Release No. 7881 (Aug. 15, 2000).

disclosure by public companies to institutional investors and others in the financial services industry.<sup>65</sup> Notably, Regulation FD was adopted by the SEC pursuant to its authority to regulate disclosures by public companies. The rule specifically disclaims defining selective disclosure as fraudulent.<sup>66</sup> This is by necessity; under *Dirks*' personal benefit standard, simple breaches of confidentiality are not deceptive.

Apart from its rulemaking efforts, the SEC also persuaded lower courts to adopt broad interpretations of *Dirks*' personal benefit requirement. The SEC's efforts to undermine *Dirks* ultimately culminated with the Second Circuit's decision in *SEC v. Obus*.<sup>67</sup> In *Obus*, the Second Circuit rejected the SEC's argument that the *Dirks* personal benefit test should not apply in cases asserting a violation of the misappropriation theory (unlike the classical theory at issue in *Dirks*).<sup>68</sup> That was a minor setback for the SEC, however, as the Court read *Dirks* in a manner that was very generous to the agency, but that generosity to the SEC came at the expense of fidelity to Justice Powell's opinion in *Dirks*. The *Obus* Court laid out its understanding of the elements for tipper liability:

To be held liable, a tipper must (1) tip (2) material non-public information (3) in breach of a fiduciary duty of confidentiality owed to shareholders (classical theory) or the source of the information (misappropriation theory) (4) for personal benefit to the tipper. The requisite scienter corresponds to the first three of these elements.<sup>69</sup>

The last sentence is a non sequitur; nothing in *Dirks* suggests that the *scienter* element does not apply to element of personal benefit, and the Second Circuit does not cite any authority for that proposition. The *Obus* court goes astray because it ignores that the *Dirks* personal benefit test requires not just that tippers *receive* a personal benefit, but that they disclose confidential information for the *purpose* of receiving a personal benefit.<sup>70</sup> The absence of a personal benefit will end that inquiry, but the presence of one is not dispositive: purpose must still be shown. That purpose requirement necessarily means that the breach of duty and state of mind inquiries will sometimes overlap: "Scienter in some cases is relevant in determining whether the tipper has violated his *Cady, Roberts* duty."<sup>71</sup> *Dirks* does not suggest that the scienter requirement should not apply to the element of personal benefit, but a disclosure cannot be deceptive

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65. 17 C.F.R. § 243.100 *et seq.*

66. 17 C.F.R. § 243.102 ("No failure to make a public disclosure required solely by [Regulation FD] shall be deemed to be violation of Rule 10b-5 under the Securities Exchange Act.").

67. 693 F.3d 276 (2d Cir. 2012).

68. *Id.* at 285–86.

69. *Id.* at 286. Number three appears to be simply wrong; insiders are breaching a duty of *disclosure* to shareholders under the classical theory. The insider's duty of confidentiality runs to the corporation.

70. *Dirks*, 463 U.S. at 659 (Insiders "may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain.").

71. *See id.* at 663.

under *Dirks* unless a personal benefit was the object of the disclosure. The duty question is logically prior in the *Dirks* framework.

Having streamlined the requirements for tipper liability, the *Obus* court proceeded to dilute the requirements for tippee liability. The *Obus* court quotes *Dirks*' language that the tippee inherits the insider's duty only when "the tippee knows or should know that there has been a breach,"<sup>72</sup> suggesting that it "sounds somewhat similar to a negligence standard."<sup>73</sup> The history of the personal benefit standard outlined above demonstrates that Powell was addressing the question of duty, not state of mind, with that formulation. Tippee liability is derivative of the tipper's breach of fiduciary duty: "Only if there [is] such a breach [does] a tippee, acquire a fiduciary duty to disclose or abstain."<sup>74</sup> But it is a fiduciary duty of a particular sort that the tippee is acquiring. The tippee must be shown to have breached that duty to satisfy the element of deception, a question separate from the element of scienter. There was no occasion to address *Dirks*' state of mind, as *Secrist* had violated no duty.<sup>75</sup> As noted above, there is no reason to think that the inclusion of the "should know" language meant Powell was diluting the scienter element that he had championed in *Ernst & Ernst v. Hochfelder*.<sup>76</sup> But the *Obus* court effectively guts the scienter requirement for tippees. The key move:

We think the best way to reconcile *Dirks* and *Hochfelder* in a tipping situation is to recognize that the two cases were not discussing the same knowledge requirement when they announced apparently conflicting scienter standards. *Dirk's* [sic] knows or should know standard pertains to a tippee's knowledge that the tipper breached a duty, either to his corporation's shareholders (under the classical theory) or to his principal (under the misappropriation theory), by relaying confidential information.<sup>77</sup>

This is a possible—but scarcely inevitable—reading of "knows or should know" standard in isolation: "should know" *could* mean negligence. A more faithful reconciliation of *Dirks* and *Ernst & Ernst v. Hochfelder*, however, would require recklessness for the tippee's knowledge of the personal benefit. As Powell reminds us in *Dirks*, the elements of duty and scienter—although distinct—will frequently overlap. The *Obus* court's formulation that the tippee can be complicit in the tipper's breach if the "tippee knew or had reason to know that confidential information was initially obtained and transmitted improperly (and thus through deception)" ignores a critical portion of the *Dirks* personal benefit test.<sup>78</sup> The breach of duty must not only be a breach of confidence, which might be

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72. *Obus*, 693 F.3d at 287 (quoting *Dirks*, 463 U.S. at 660).

73. *Id.*

74. *Dirks*, 463 U.S. at 662 n.23.

75. *Id.*

76. 425 U.S. 185 (1976).

77. *Obus*, 693 F.3d at 288.

78. *Id.* at 288; *see also id.* at 292 (holding a breach of duty of confidentiality sufficient to put tippee on notice of breach of fiduciary duty).



done negligently: the disclosure must be for the purpose of self-enrichment.<sup>79</sup> The *Obus* court splits the breach of confidentiality from the purpose of receiving a personal benefit, which undercuts *Dirks*' insistence that "there is no general duty to forgo market transactions 'based on material, nonpublic information.'"<sup>80</sup> The *Obus* court relegates the scienter inquiry to other elements of the tippee's violation, specifically, the use of the information. But a court applying *Dirks*—and *Ernst & Ernst*—should separately address whether the tippee acted with scienter in participating in the insider's breach of fiduciary duty. The breach of fiduciary duty by the insider is the gravamen of the deceptive conduct. The deception requirement, which goes back to *Santa Fe*, is the focus of the *Dirks* test.<sup>81</sup>

#### IV. NEWMAN

The impact of the wrong turn in *Obus* became apparent soon enough. *Newman* arose from the criminal prosecution of two hedge fund managers who were at the end of extended tipping "chains." Through those chains, the managers received confidential information about impending earnings releases from public companies. At their trial, the district court, following *Obus*, instructed the jury that:

To meet its burden, the [G]overnment must also prove beyond a reasonable doubt that the defendant you are considering knew that the material, nonpublic information had been disclosed by the insider in breach of a duty of trust and confidence. The mere receipt of material, nonpublic information by a defendant, and even trading on that information, is not sufficient; he must have known that it was originally disclosed by the insider in violation of a duty of confidentiality.<sup>82</sup>

The trial court rejected the defendants' request that the jury be charged that it had to find that the defendants "knew that the corporate insiders had disclosed confidential information for personal benefit."<sup>83</sup>

The court of appeals rejected the argument that a breach of confidentiality was sufficient for insider trading. Instead, the *Newman* court adopted a more demanding standard for tippee liability:

For purposes of insider trading liability, the insider's disclosure of confidential information, standing alone, is not a breach. Thus, without establishing that the tippee knows of the personal benefit received by the insider in exchange for the disclosure, the government cannot meet its burden of showing that the tippee knew of a

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79. *Dirks*, 463 U.S. at 657–58 (rejecting SEC's theory of tippee liability based on "a duty to disclose or abstain solely because a person knowingly receives material nonpublic information").

80. *Id.* at 666 n.27 (quoting *Chiarella v. United States*, 445 U.S. 222, 233 (1980)).

81. *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473 (1976) (holding that liability under Rule 10b-5 requires manipulation or deception).

82. *Newman*, 773 F.3d at 444.

83. *Id.*

breach.<sup>84</sup>

This standard marked a sharp departure from *Obus*—which allowed tippee liability on a simple showing of awareness of a breach of confidentiality—and a return to *Dirks*' requirement of knowledge of a personal benefit to the tipper.

The two decisions might be distinguished on the ground that *Newman* involved the criminal standard that the defendant acted “willfully,”<sup>85</sup> but the conflict between *Newman* and *Obus* on the elements of tippee liability—a Rule 10b-5 question—is not so easily reconciled. *Newman* requires that the tippee know that the tipper received a personal benefit for disclosing confidential information, while *Obus* requires only that the tipper know that the tippee was breaching a confidence. *Newman* is more faithful to Powell's understanding of the personal benefit test and the requirement that the tippee be a participant in the insider's fraudulent breach of fiduciary duty. *Dirks* is explicit that simply breaching a duty of confidence does not constitute “deception.” How can a tippee be a participant after the fact in the breach of fiduciary duty if they do not know of the breach?

The *Newman* court dealt the U.S. Attorney's campaign against insider trading another blow, however, when it defined “personal benefit.” The mere fact of friendship between a tipper and tippee was not enough; there had to be “proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature.”<sup>86</sup> It is this restrictive definition that provoked the sharp reactions from the U.S. Attorney and SEC quoted in the introduction. Does the *Newman* court's definition of “personal benefit” deviate from Justice Powell's understanding in *Dirks*?

In my view, this question is a close one. In *Dirks*, Powell offers as an example of a personal benefit: “The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to trading relative or friend.” Powell does not qualify how close the relative or friend must be. The Justice Department and the SEC argue that the absence of a qualifier was deliberate: a showing of friendship should be enough, and they have found plenty of lower courts willing to accept that view.<sup>87</sup> The judicial history of *Dirks* presented above does not support the government's position. Given that Secrist had violated no duty, the tippee's required quantum of friendship with the tipper could be resolved in a later case. The proffered example was not intended as the ultimate rule. Moreover, Powell had no occasion to consider the issues created by information passing along an extended

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84. *Id.* at 448.

85. 15 U.S.C. § 78ff(a) (2012).

86. *Newman*, 773 F.3d at 452.

87. See, e.g., *SEC v. Sargent*, 229 F.3d 68, 77 (1st Cir. 2000) (disclosure by tipper to dentist conferred personal benefit). *But see SEC v. Maxwell*, 341 F. Supp. 2d 941, 946 (S.D. Ohio 2004) (tip to tipper's barber did not meet personal benefit requirement).

chain before being traded on. It was not raised by the facts in *Dirks*, and there is nothing in Powell's file that would suggest that an extended chain of information was considered.

The stronger counter-argument to the government's position—that only a minimal relationship is required—is that the personal benefit element requires the government to prove that the tipping insider disclosed the information for the *purpose* of receiving a personal benefit, direct or indirect. Would the existence of a casual friendship or acquaintance warrant the inference that the insider breached a duty of confidentiality for the *purpose* of bestowing a gift? That seems like more of a stretch than passing the information on to a sibling, or one's child, where we might be willing to draw an inference of an indirect personal benefit to the tipper in most cases. Even in that context, the casual way that some corporate executives bandy about confidential corporate information in their own homes should give us pause before drawing an inference of deception.<sup>88</sup> The concern becomes more acute in a criminal context, where *Newman's* holding is likely to have the most traction.

Powell crafted his opinion carefully to exclude careless breaches, and *Newman* construed personal benefit in light of that goal. The test requires the purpose to make a gift, and although some people may be committing random acts of kindness when they bestow information on a stranger, it seems much more likely that they have been careless in disclosing. To phrase it differently, the gift needs to be exploitation, not waste (the corporate law term for a hypothetical gift to a stranger). Giving away corporate information to strangers might make you feel like a big shot, but the standard is self-dealing: the gift needs to be an indirect personal benefit, which suggests a close relationship, not a casual one. Tying the gift prong to the presence of a friend or relative—and requiring the government to satisfy a non-trivial quantum of proof with respect to that relationship—restricts the SEC from coming up with strained theories of gifting by insiders. Powell was very much worried about the SEC's penchant for novel theories, and the primary purpose of the personal benefit standard in *Dirks* is to fence the agency in. *Newman's* interpretation of personal benefit is consistent with, if not compelled by, Powell's purpose in *Dirks*.

## V. CONCLUSION

I have argued in this essay that the evolution of *Dirks's* personal benefit standard supports the reasoning of *Newman* and undercuts the approach in *Obus*. That conclusion, however, is based not only on the published opinion in *Dirks*, but also the “judicial history” that led to that opinion. How much legal weight does that judicial history deserve? The conven-

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88. SEC v. Rocklage, 470 F.3d 1 (1st Cir. 2006) (CEO shared information with wife about failed drug trial).

tional answer is none.<sup>89</sup> Some arguments against the use of legislative history—the text was what was voted on, presentment, etc.—do not quite fit to judicial history. There are only nine voters in this context, and the evolution of the personal benefit standard from the justices’ initial conference in *Dirks* to joining Powell’s final opinion was transparent. Powell told his fellow justices what he was doing and why: he was promulgating a rule to constrain the SEC. On the other hand, a commitment to the rule of law would seem to support the notion that the published opinion *is* the law. That would certainly be the expectation of both Powell and his colleagues. And what effect would reliance on judicial history have on the internal deliberations of the justices?<sup>90</sup>

These are weighty reasons for a court to ignore judicial history of the sort presented here when deciding a case that requires the application of precedent. But the claim of the U.S. Attorney and the SEC that *Newman* conflicts with *Dirks* does not hold up when assessed against this judicial history. Should such claims go unchallenged? Hard question, particularly in a criminal case in which the defendants have narrowly escaped doing hard time.

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89. See Adrian Vermeule, *Judicial History*, 108 YALE L.J. 1311, 1313 (1999) (“Federal courts do not consider the judiciary’s internal records as interpretive sources bearing on the meaning of published opinions or judicially-promulgated rules.” (citations omitted)).

90. *Id.* at 1316 (“Resort to judicial history would distort the Court’s internal deliberations, render the history unreliable, and undermine various rule of law norms associated with judicial decisionmaking.”).

