ADMINISTRATIVE PROCEEDING
FILE NO. 3-5068

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of :

THE BOSTON COMPANY INSTITUTIONAL :
INVESTORS, INC. :
JOHN W. BRISTOL & CO., INC. :
RAYMOND L. DIRKS :
THE DREYFUS CORPORATION :
MANNING & NAPIER :
TOMLIN, ZIMMERMAN & PARMELEE, INC. :

INITIAL DECISION

September 1, 1978
Washington, D.C.

David J. Markun
Administrative Law Judge

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APPEARANCES:

Donald N. Malawsky , Associate Administrator, Enforcement, New York Regional Office; Jason R. Gettinger and Andrew N. Karlen, Attorneys; and Roger M. Deitz, Special Counsel, for the Division of Enforcement. Paul S. Maco assisted on the reply brief.

Marshal Simonds, Thomas J. Griffin, Jr. and Carol Goodman, of Goodwin, Procter and Hoar, Boston, Mass., for Respondent The Boston Company Institutional Investors, Inc.

Peter M. Brown, Claude P. Bordwine and Howard W. Burns, Jr., of Cadwalader, Wickersham & Taft, New York, N.Y., for Respondent John W. Bristol & Co., Inc.

David Bonderman and David Hird, of Arnold & Porter, Washington, D.C., for Respondent Raymond L. Dirks.

Lawrence Greenwald and Bruce H. Schneider, of Stroock & Stroock & Lavan, New York, N.Y., for Respondent The Dreyfus Corporation.

Robert C. Napier, of Napier & Lapine, Rochester, New York, for Respondent Manning & Napier.

Robert A. Meister, of Milgrim Thomajan & Jacobs, New York, N.Y., for Respondent Tomlin, Zimmerman & Parmelee, Inc.

BEFORE:

David J. Markun
Administrative Law Judge

I

THE PROCEEDING

This public proceeding was instituted by an Order of the Commission dated August 24, 1976, as amended on September 10, 1976 and on October 12, 1977 ("Order"), pursuant to Sections 15(b) and 19(h) of the Securities Exchange Act of 1934 [1/], Section 203(e) of the Investment Advisers Act of 1940 [2/], and Section 9(b) of the Investment Company Act of 1940 [3/], to determine whether one individual respondent and five corporate respondents wilfully violated or wilfully aided and abetted violations of Section 17(a) of the Securities Act of 1933 [4/] or Section 10(b) of the Exchange Act of 1934 and Rule 10b-5 thereunder [5/], and the remedial action, if any, that might be appropriate in the public interest. In substance, the allegations of the Division of Enforcement ("Division") contained in the Order charge violations of the rule against inside information trading in connection with various sales of the securities of Equity Funding Corporation of America in March of 1973 by the five

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1/ 15 U.S.C. § 78o (b); 15 U.S.C. § 78s (h).

2/ 15 U.S.C. § 80b--3(e).

3/ 15 U.S.C. § 80a--9(b).

4/ 15 U.S.C. § 77q(a).

5/ 15 U.S.C. § 78j (b); 17 CFR 240.10b-5

corporate respondents on behalf of their clients.

The evidentiary hearing was held in New York, New York, and, in part, in Los Angeles, California. All parties have been represented by counsel thoughout the proceeding. The parties have filed proposed findings of fact and conclusions of law and supporting briefs pursuant to the Commission's Rules of Practice (17 CFR 201.16). Respondents filed both joint proposed findings and conclusions and supporting memorandum and individual proposed findings and conclusions and memoranda.

The findings and conclusions herein are based upon the record and upon observation of the demeanor of the various witnesses. The standard of proof applied is that requiring proof by clear and convincing evidence. 6/

6/ The Court of Appeals for the District of Columbia Circuit has held that in an administrative proceeding brought by the Commission to determine whether a broker-dealer and its president had violated antifraud provisions of the federal securities laws and in which the sanction in question involved "an expulsion or a substantial suspension order" the "clear and convincing" standard of proof rather than the long-standing "preponderance of evidence" standard of proof should have been applied. Collins Securities Corporation v. S.E.C., 562 F. 2d 820, decided Aug. 12, 1977, as amended on denial of request for rehearing September 23, 1977. Although a petition for certiorari from the Supreme Court was not sought in Collins, the Commission has continued to assert in other proceedings that the preponderance of the evidence standard is legally sufficient in all administrative proceedings under the securities laws, e.g. Charles W. Steadman v. S.E.C., No. 77-2415, currently pending in the Court of Appeals for the Fifth Circuit, an appeal from the Commission's decision in Steadman Security Corporation, et al., Investment Company Act of 1940 Release No. 9830, June 29, 1977, 12 SEC Docket 1041, July12, 1977. In the Steadman appeal the Commission urges that Collins conflicts with an earlier decision of that same circuit (Abbett, Sommer & Co., Inc. v. Securities and Exchange Commission, ['70-'71] Fed. Sec. L. Rep. [CCH] ¶ 92,813 (1970), cert. den., 401 U.S. 974 (1971)); with decisions of the Court of Appeals for the Second Circuit (De Mammos v. S.E.C., C.A. 2, No. 31469 (Oct. 13, 1967), affirming James De Mammos,

II

FINDINGS OF FACT AND LAW

A. The Respondents; Background concerning their knowledge of and interest in Equity Funding prior to hearing alleged inside information in March, 1973.

EFCA

As noted, the corporation in whose securities the alleged illegal transactions occurred in violation of the inside-information proscription was Equity Funding Corporation of America ("EFCA" or "Equity Funding"), a California corporation with principal offices in Los Angeles. EFCA is not a respondent but some findings concerning it are essential to understanding related findings and conclusions.

6/ (footnote continued)

43 S.E.C. 333 (1967); Wright v. S.E.C., 112 F. 2d 89 (C.A. 2, 1940); and with a long line of the Commission's decisions (Richard C. Spangler, Inc., Securities Exchange Act Release No. 12104, 8 SEC Docket 1257 (February 12, 1976), remanded on other grounds sub nom. Nassar and Co. v. Securities and Exchange Commission, ['77-'78] Fed. Sec. L. Rep. [CCH] ¶96, 185 (C.A. D.C., October 3, 1977); Sidney Leavitt, Securities Exchange Act Release No. 10013, 1 SEC Docket 1 (February 22, 1973); M.V. Gray Investment, Inc., 44 S.E.C. 567, 575 (1971); In re Norman Pollisky, 42 S.E.C. 458, 459-460 (1967); Underhill Securities Corp., 42 S.E.C. 689, 695 (1965); White and Weld, 3 S.E.C. 466, 539-540 (1938).) In view of the conflict among the Circuits on this point and in light of the forums available on any appeal that may be taken, it is concluded that the more appropriate course is to apply the "clear and convincing" standard of proof in this proceeding.

From 1960 to 1966 EFCA had been essentially a marketing organization selling life insurance, shares in mutual funds, and funding programs combining the two. In 1967 it had embarked upon a diversification program that included the acquisition of investment companies, insurance companies, marketing companies, a savings and loan association, certain foreign operations, partnerships in oil and gas exploration and cattle breeding, and a real estate development enterprise. Thus, by March, 1973, EFCA had taken on the aspect of a substantially diversified enterprise; nevertheless, its primary business continued to be sales of life insurance, mutual funds, and funding programs combining the two.

EFCA's insurance business was conducted through its subsidiaries, Equity Funding Life Insurance Company, domiciled in Illinois but with its principal offices in Los Angeles ("EFLIC"), Bankers National Life Insurance Company, Parsippany, New Jersey ("Bankers" or "Bankers National"), Northern Life Insurance Company, Seattle, Washington ("Northern"), and Equity Funding Life Insurance Company of New York, New York, a subsidiary of Bankers ("EFNY"). EFLIC's insurance products were marketed by EFCA's sales force, whereas the other insurance subsidiaries of EFCA primarily utilized general agents.

EFCA first issued its securities to the public in 1964. From time to time thereafter, EFCA issued notes, convertible debentures, and similar securities to the public. 7/ Each of these was issued pursuant to a registration statement filed with the Commission. During this period EFCA filed periodic reports with the Commission pursuant to the Exchange Act.

EFCA common stock and its 5-1/2 percent convertible subordinated debentures due in 1991 ("convertible debentures" or "debentures") were listed and traded on the New York Stock Exchange. EFCA warrants were listed and traded on the American Stock Exchange.

Dirks

In March of 1973 Respondent Raymond L. Dirks ("Dirks") was a security analyst specializing in insurance stocks at Delafield Childs, a broker-dealer in New York, New York, having exclusively institutional clients. Earlier, in 1969, Dirks and his brother had formed a broker-dealership known as Dirks Brothers; that business was dissolved when Dirks joined Delafield Childs in December, 1971, where he became a senior vice president in charge of the Dirks Brothers Division, a research group

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7/ These issues consisted of $2 million of 5-1/2 percent capital subordinated notes due in 1980 with common stock purchase warrants, issued in 1965; $6 million of 5-1/2 percent convertible debentures due in 1982, issued in 1967; $22 million of 9-1/2 percent debentures due in 1990 with common stock purchase warrants, issued in 1970; and $38 million of 5-1/2 percent convertible subordinated debentures due in 1991, issued in 1971.

comprising Dirks, his brother (whose expertise was in another area) and four other analysts that specialized in insurance stocks. Dirks's clients were exclusively institutions such as large commercial bank trust departments, investment companies, foundations, hedge funds, and other entities that managed securities portfolios.

The Dirks Brothers Division distributed information about and analyses of insurance companies to approximately 500 actual or potential institutional clients. Written reports were provided monthly on two or three companies and a statistical analysis covering about 50 companies was also issued about once a month. In addition to publishing materials, Dirks and his fellow analysts also contacted clients and potential clients personally with respect to insurance company securities.

Compensation for these analytical services of the Dirks Brothers Division was obtained indirectly from securities transactions directed by their clients through the Delafield Childs trading department. Such securities transactions did not necessarily or even usually involve insurance securities that were analyzed by Dirks Brothers.

Following graduation from college in 1955, Dirks until 1967 had been employed mainly as a securities analyst for various banks and firms.

On August 31, 1972, Dirks was the subject of a "profile" style article in the Wall Street Journal, which touched upon his background and methods as an analyst, and included evaluations of him, albeit sketchy, by his analyst peers. The article was generally favorable to Dirks, and among other things emphasized his dogged and sometimes innovative means for digging into relevant facts about a company. The article was written in the context of the difficulties small securities analyst firms were then experiencing and suggested that for at least some of them specialization might be the key to their survival.

While Dirks had not made any special analysis of Equity Funding, he was generally familiar with it from the time of its public offerings in the early '60s and had occasion from time to time to comment on the firm in conversations with other securities analysts and portfolio managers, and at least once in a written comment in the Dirks Brothers publication "Insurance Confidential - Ideas on Insurance Stocks" of February 15, 1972.

In 1971, at the request of EFCA's public relations firm, Dirks held a luncheon at which Stanley Goldblum, Chairman of the Board of Equity Funding, and other officers of EFCA, including Fred Levin and Sam Lowell, spoke to a gathering of analysts and portfolio managers.

Sometime after the day of the luncheon, Goldblum asked Dirks to attempt to ascertain whether Allen Abelson of Barron's

was about to publish a (apparently unfavorable) story about EFCA, and Dirks did so, reporting that on the basis of his guarded inquiries he did not think there would be a report.

In early 1972, Goldblum called at Dirks's office and invited him, with another, to breakfast. Among other things discussed was EFCA's recent acquisition of Bankers National Life of New Jersey.

Dirks's other contacts with EFCA personnel prior to March of 1973 included encountering Fred Levin, Executive Vice President of EFCA and President of EFLIC, at a party, and one meeting and a number of phone conversations with Patrick Hopper, then EFCA's Vice President for Investment.

Respondent III

Respondent The Boston Company Institutional Investors, Inc. ("III"), a Massachussetts corporation having its principal place of business in Boston, has been registered since 1970 as an investment adviser under Section 203 [8/] of the Investment Advisers Act of 1940. Respondent III is a subsisiary of The Boston Company, Inc. ("TBC" or "The Boston Company"), a holding company. In March, 1973, 58% of III was owned by TBC and the balance was owned by III officers Thomas W. Courtney, president, David A. Baker, senior vice president, Grayson M.P. Murphy, senior vice president, and John Wise, Jr. Other officers of

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8/ 15 U.S.C. § 80b--3.

III included Daniel Fuss and Gerald S. Zukowski, both vice presidents. William R. Moore was the firm's trader.

III rendered its investment advisory services primarily to pension and profit-sharing plans for the benefit of employees of business corporations and governmental entities.

In March, 1973, Courtney, Murphy, Baker and Fuss had primary account responsibility for client portfolios. Zukowski had also been designated a portfolio manager by that time but as of March 7th he had been delegated primary account responsibility for only one client. Wise, responsible for various marketing and administrative matters, had no primary account responsibilities, though he did participate in the management of some portfolios in a secondary or tertiary capacity. Each account had a designated primary, secondary, and tertiary portfolio manager. III also followed a practice under which a negative vote by two portfolio managers could veto a proposed transaction in a client's account.

Between May 27, 1971 and February 28, 1973, III purchased 408,000 shares of EFCA common stock at a cost of approximately $14,550,000 and $850,000 in face amount of EFCA debentures, at a cost of approximately $950,000, on behalf of 20 of its clients. By the end of February, 1973, EFCA was the third largest holding in III client portfolios.

III's initiation of purchases of EFCA securities in the Spring of 1971 and its continuation of such purchases through late 1972 had been prompted by the fact that EFCA had historically enjoyed an outstanding growth record within the insurance industry. EFCA stock had appeared to the III portfolio managers to represent one of the better values in the market place in view of its attractive price and very low price-earnings ratio as compared with comparable growth stocks for that period.

Beginning in about September, 1972, senior management of The Boston Company had become more active in reviewing the activities of III, particularly in the person of William W. Wolbach, then president and chief operating officer of TBC and also a director of III. TBC management had become concerned that a substantial percentage of the stocks purchased for the III portfolios were not stocks followed by or recommended by TBC's Investment Research and Technology arm ("IRT"), an investment research group, and were not on the so-called monitor list of stocks approved by the Investment Strategy Group ("ISG") of TBC. From that time forward Wolbach had kept pressing Courtney to have III establish new investment policy guidelines that would call for substantially greater use of TBC's monitor list of stocks. After a number of meetings and discussions among the III portfolio managers, they had arrived at an informal understanding in late January or early February that their

revised investment guidelines would aim at having not less than 80% of the aggregate composition of III portfolios consist of monitored stocks by the end of 1973. To begin implementation of that objective, it had been agreed that purchases of non-monitored stocks would be curtailed.

Beginning about December of 1972, portfolio managers at III had begun their own internal, somewhat informal analysis of EFCA. Zukowski had recently joined III, and since he had had some background in insurance stocks, he was the portfolio manager who primarily concerned himself with looking into EFCA; however, since EFCA stock was held by other portfolio managers as well, they too gathered information and views and exchanged information and opinions with Zukowski and with one another. The inquiry had included a one-day visit by Zukowski and Baker to EFCA's offices in Los Angeles, where they conferred with EFCA's president and various other officials sometime before Christmas of 1972. After the visit to EFCA's offices, III portfolio managers continued to talk to outside analysts, broker-dealers, and others with respect to matters that bore on evaluation of EFCA as a holding.

In late December Zukowski had talked about EFCA to Ray Dirks, whom he had earlier come to know in the course of their employment in another firm, but had found that Dirks was not closely following EFCA.

By memorandum of February 2, 1973, Courtney had requested Zukowski to prepare a comprehensive report on EFCA to be submitted to the ISG with a view to getting EFCA placed on the monitor list of approved stocks. Zukowski's draft report,[9] given to Courtney sometime between February 13 and February 23, was also circulated among the other portfolio managers. The draft was in the main positive but it did call attention as well to a number of specific negative factors respecting Equity Funding. Zukowski recommended to Courtney that the report not be submitted to the ISG because of the negative factors. After some further discussions with Zukowski and after the draft report had circulated among the other portfolio managers, Courtney had decided not to submit the report that would have sought to get EFCA onto the monitored list.

Earlier, on February 14, 1973, Zukowski and Wise had attended a luncheon in Boston sponsored by Edwards & Hanly for EFCA officers Stanley Goldblum, Fred Levin and Sam Lowell. After the luncheon, Goldblum and Levin had visited III's offices.

The upshot of it all was that at the close of February and during the first week of March, 1973, there was among the portfolio managers at III no clear consensus regarding EFCA. However, there was a _prevailing_ view among them that they

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9/ Division's Ex. 20.

should await an anticipated rebound in the price of the stock to the low or mid 30s before considering sale of some or all of the EFCA securities.

Bristol & Co.

Respondent John W. Bristol & Co., Inc. ("Bristol & Co."), a New York corporation having its principal place of business in the City of New York, has been registered as an investment adviser under the Investment Advisers Act since 1954. John W. Bristol ("Bristol") is Chairman of the Board and Chief Executive Officer of Bristol & Co., and held such positions in March, 1973.

Since 1968 Bristol & Co. has been a wholly owned subsidiary of TBC. However, Bristol & Co., under an express provision of the acquisition agreement, has operated with total autonomy in its investment decisions and was so operating in March, 1973. Thus, Bristol & Co. did not during the relevant period discuss with TBC or TBC's other subsidiaries Bristol & Co.'s investment decisions or the composition of its clients' investment portfolios.

Bristol & Co. is and was during the relevant period engaged in rendering investment advisory services to various organizations, financial institutions, pension funds and foundations, including a number of endowment funds for various schools, colleges, and universities. As of December, 1972 its clients' portfolios totalled some $1.5 billion.

Between December, 1971, and March 22, 1973, Bristol & Co. purchased for its clients a total of 457,000 shares of EFCA common stock and $200,000 face value of its convertible debentures. The Bristol Employees Profit-Sharing Plan purchased 600 EFCA shares in January, 1973.

The purchases were made because of EFCA's reported outstanding growth rate within the specialty insurance industry; its reportedly strong sales force that marketed a unique investment package combining elements of life insurance and mutual fund shares and interrelated financing; its apparent position for capitalizing on the growing interest in, and the Commission's recent approval of variable annuities for purchase by mutual funds; and its very low price/earnings ratio relative to comparable growth stocks.

Notwithstanding these positive factors, three individuals from three separate investment committees functioning for Bristol & Co.'s clients had expressed dissatisfaction with or lack of enthusiasm for the EFCA securities purchases.

As late as March 21, 1973, John Bristol personally sought and obtained permission from the Investment Committee of Princeton University to purchase EFCA stock. Because of subsequent events that are detailed in Part II B below, only 66,000 shares of the intended larger purchase of EFCA shares were bought on March 22, 1973.

The Dreyfus Corporation

Respondent The Dreyfus Corporation ("Dreyfus") has been registered as an investment adviser under Section 203 of the Investment Advisers Act of 1940 since December 10, 1971. In March, 1973, Dreyfus was the investment adviser for several registered mutual funds, including the Dreyfus Fund ("DF") and the Dreyfus Special Income Fund ("DSIF"). At that time Michael L. Quinn was employed by Dreyfus as a portfolio manager. He began to assume responsibility for DSIF's equity investments shortly before or in March, 1973, sharing that responsibility with Joseph DiMartino. Howard Stein was the chief investment officer for DF and DSIF.

In March of 1973 Anthony Orphanos was a securities analyst with Dreyfus, covering the insurance industry for all portfolio managers. Among the other sources he consulted, Orphanos used the Dirks Brothers insurance stocks report and consulted Allen Gorrelick, an associate of Dirks's, from time to time. Orphanos knew Dirks primarily by reputation.

Prior to March, 1973, Quinn was not acquainted with Dirks.

In early 1973 the Dreyfus Fund acquired a position in EFCA, which had only recently become an investment eligible for purchase by mutual funds.

On March 21, 1973, DSIF purchased from Goldman, Sachs & Co., acting as principal, $500,000 face amount of EFCA convertible

debentures at a net cost of approximately $388,937.

Manning & Napier

Respondent Manning & Napier ("M & N") in March, 1973, was a partnership that had been registered since May of 1970 as an investment adviser under Section 203 of the Investment Advisers Act. Its office was then and is now located in Rochester, New York. 10/

In March, 1973, M & N provided counseling on a full time basis to individuals and tax-exempt pension funds. William Manning was a managing partner; he had final decision-making authority within the firm over all equity purchases and sales for client accounts.

As of March of 1973,M & N serviced some 90 to 100 clients and managed about $20-25 million in assets.

On May 18 and 19 and June 7, 1972, M & N had purchased a total of 5,975 EFCA common shares for 19 of their client accounts.

Manning had become concerned with the price action of EFCA stock in the second half of 1972 and as a result had sold the holdings of three clients, based in part on the risk he felt those clients could take. In February, 1973, he sold out another client's EFCA shares after deciding that she could not

10/ In late 1973 Manning and Napier Advisers, Inc., a corporation, succeeded to the business of M & N and became registered as an investment adviser under Section 203. William Manning and William Napier each own 50% of M & N Advisers.

afford the risk of further price diminution.

During the last half of 1972 and the first quarter of 1973 Manning discussed EFCA with William Reeves, a sales agent in EFCA's Rochester, New York, office, whom Manning considered to be financially knowledgeable. These discussions occurred when the two would meet without prearrangement at a local pub for an hour or two on Friday nights.

Manning had discussed with Reeves during the first quarter of 1973 two specific rumors about EFCA: (a) that the New York State Department of Insurance was investigating and might reverse EFCA's recent acquisition of Bankers National, and (b) that First National City Bank might decline to renew EFCA's credit line. Reeves checked out those rumors with the manager of EFCA's Rochester office and with EFCA's Eastern Sales Manager and reported to Manning that there was no substance to either rumor.

Manning considered insider selling of EFCA stock of importance and had monitored it closely during the first quarter of 1973. In February he had asked Reeves about such sales. Reeves, after checking with his branch manager and with Herbert Glaser, an executive vice-president of EFCA who worked in EFCA's home office, had reported that such sales were all for personal reasons such as home improvements, tax payments, and the like. Manning had received such explanations with skepticism.

In January and February of 1973 Manning and Reeves had

also discussed a recent change in the law that had enabled mutual funds to invest in EFCA stock. The extent of such purchases by mutual funds was not as great as Manning and Reeves had both expected it might be.

During February Manning had had an assistant, Karen Calvert, commence monitoring EFCA for daily price fluctuations. A small number of other stocks was similarly monitored.

In the first quarter of 1973 Manning's attitude towards EFCA had become progressively more pessimistic. For about a week to 10 days prior to M & N's liquidation of its clients' positions in EFCA, Manning had considered selling the stock for a variety of reasons, among which its negative price action figured perhaps most prominently.

TZP

Respondent Tomlin, Zimmerman & Parmelee, Inc. ("TZP") has been registered since September, 1972, as an investment adviser under Section 203 of the Investment Advisers Act. Its place of business in March of 1973 was, and is today, in New York, New York.

Donald R. Tomlin and Charles Zimmerman were principals of TZP in March, 1973, as they are today. Tomlin was then a portfolio manager and analyst who followed, among others, the insurance company stocks. Zimmerman then performed general

investment work for all of the TZP accounts and was the firm's trader. 11/ In the field of analysis of insurance company securities Tomlin had a reputation as a " knowledgeable guy."

In March, 1973, TZP acted as investment adviser for some 11 accounts, which included pension funds, college endowments, and an insurance company. Assets under management totalled approximately $75 million.

Except for the insurance company, 12/ which TZP merely advised and which made its own investment decisions, and two pension fund accounts which required oral approval of one trustee before TZP could execute transactions on their behalf, TZP's clients had given it discretionary power to purchase and sell securities for their accounts.

Tomlin and Zimmerman had commenced purchasing EFCA securities for clients in May, 1971, when they were principals of TZP's predecessor. EFCA was added to their "buy" list because research showed that the company was writing profitable life insurance, was increasing its sales at a greater rate than the average life insurance company, was showing greater earnings progress than the average life insurance company, and had come

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11/ When TZP was incorporated Alfred Parmelee had also been a principal of TZP and was such during the period relevant to this proceeding. However, he had nothing to do with the matters at issue in this proceeding and, by the time of the hearing in this proceeding he had withdrawn from the firm and had sold his interest in TZP to Tomlin and Zimmerman.

12/ The insurance company did not purchase any EFCA securities.

through a difficult period in the market as a continuing strong stock.

Between May, 1971, and March 23, 1973,TZP (and its predecessor) purchased for its clients' accounts some 25,920 shares of EFCA and $60,000 face amount of EFCA convertible debentures.

On March 13, 1973, Tomlin noted in the Wall Street Journal a report of a March 12, 1973 press release by EFCA, and on March 20, 1973, he received and read a copy of the release itself. The EFCA press release reported record earnings for 1972 and an increase in life insurance sales. EFCA as a consolidated entity was reported as having sold $2.5 billion of life insurance in 1972, bringing total insurance in force as of December 31, 1972 to $6.5 billion, compared with $4.6 billion at the close of 1971.

B. Respondents' Receipt in March, 1973, of non public information concerning fraud at Equity Funding; Contexts in which the information was received; Responses to receipt of the information; Recognition by Respondents of the probable market impact of the selective dissemination of the information; Involvement, role, and activities of Respondent Dirks.

Respondent III

At about 5:00 p.m. on March 12, 1973, Zukowski at III in Boston received a telephone call from Dirks in New York City. The call lasted 40 to 45 minutes. It concerned a story related

to Dirks a few days earlier concerning EFCA by a former employee of EFCA. Dirks did not disclose the identity of the former employee because his informant had told him he feared for his life. Dirks was aware of III's interest in EFCA because of his discussion of EFCA with Zukowski in December of 1972.

The story, if it could be believed, was startling. Dirks said his source had alleged that one-third of the insurance policies carried on the books of EFCA's life insurance subsidiary, EFLIC, during 1969 and 1970 were fictitious. The phony business was known as "Y" business. It was also alleged that EFLIC would sell the phony insurance to other insurance companies through co-insurance or re-insurance arrangements and that it had created fake death certificates to help carry off the scheme. Dirks also stated his source had reported that EFLIC used different names and spellings of policyholders to help dupe the auditors.

Dirks also related that his source had told him that upper-level personnel had been leaving Bankers National, another EFCA subsidiary, in inordinate numbers, and that one had left because of concern over the transfer of a deposit from one bank to another.

Although prodded by Zukowski, Dirks refused to disclose the identity of his source, indicating that the source feared Mafia retaliation at the behest of EFCA. Dirks identified

his source as a former employee of EFCA, who, while not in the accounting department, was in a position to know EFCA's business. In response to a suggestion from Zukowski that the source might be trying to short the stock, Dirks indicated his doubt of that likelihood by remarking that his source appeared to him to be a religious man.

After the conversation had gone on about 10 minutes, Courtney came or was called into Zukowski's room, and, after being filled in on the substance of the conversation to that point, Courtney got on the phone with Zukowski. Meanwhile, at some point fairly early in the conversation, Dirks's associate , Allen Gorrelick, joined the conversation on the New York end of the line.

Dirks further related that his source informed him that EFCA had forged 4 or 5 certificates of deposit during one year in order to inflate assets ; that insurance policies of $10,000 were put on the books at $25,000 and then co-insured; and that EFCA gave life insurance policies to employees free of first-year premiums as part of the reinsurance fraud.

Among the additional allegations that Dirks related in that conversation was that EFCA's auditors, Haskins & Sells, [13/] had dropped the EFCA account.

13/ The record indicates that Haskins & Sells audited EFLIC from 1968 to 1971.

Some of the participants in that conversation discussed how or whether it would be possible for fraud of the kind being alleged to remain undetected.

Courtney arranged during the phone call to meet with Dirks in New York on the following day, where he was scheduled to be in any event on other business.

After the phone call, Courtney and Zukowski discussed the matter. Zukowski told him of his high regard for Dirks, whom he had known since about 1966 or 1967. Dirks had supplied Zukowski with research reports and recommendations while the latter had been employed at other firms.

Courtney considered the market at that time to be extremely "nervous" and thought that any kind of negative rumors concerning EFCA could seriously undermine the price of its stock. Indeed, he had cautioned Dirks during the telephone conversation that he could "get into trouble" if he spread about wild rumors about EFCA. Courtney was aware that EFCA had a history of price volatility.

Between 6:00 and 6:30 p.m. (EST) Courtney and Zukowski called Haskins & Sells in California, from whom they learned that that firm had been replaced as EFLIC's auditors by Seidman & Seidman, EFCA's auditors. 14/ Haskins & Sells had not "dropped" the account.

14/ The record indicates that Haskins & Sells audited EFLIC from 1968 through 1971, while EFCA and most of its other subsidiaries were audited through 1970 by Wolfson, Weiner, a local auditing firm, and after that by Seidman & Seidman, which had acquired Wolfson, Weiner. The record also shows that in 1972 Seidman & Seidman also took over the auditing of EFLIC; on the EFCA, EFLIC, and related accounts Seidman & Seidman utilized primarily the personnel that had theretofore been engaged in auditing EFCA and most of its subsidiaries for Wolfson, Weiner.

In response to further inquiry from Courtney, Haskins & Sells' representative indicated they had not heard rumors of fraud at EFLIC.

At about 6:30 or 7:00 that evening Courtney told Wise about Dirks's call and that III was "going to unload" EFCA. Since Courtney was to be in New York the following day, Wise undertook to write up the sell tickets the following morning.

At about 7:00 that evening Courtney called Moore, the trader, at his home to tell him of the decision to sell out III's holdings of EFCA in their clients' accounts and to discuss the mechanics of handling such a large sell order. Courtney indicated he wanted the positions in EFCA sold out even if it required a big discount to do so.

On the following day, Tuesday, March 13, Courtney took a telephone call from Wise at Dirks's office in New York City prior to his meeting with Dirks. Wise advised Courtney that Baker, Murphy, and Fuss would not go along with Courtney's proposed sale of EFCA securities for client accounts that he managed. (Late in 1972 III had instituted a so-called veto system, under which a negative vote by any two or more of the portfolio managers would block a proposed buy or sell order.) Courtney was highly displeased with this response

and emphaticially directed Wise to work on the other managers to get them to sell.

Courtney then met with Dirks and his associate, Allen Gorrelick. Utilizing his notes, Dirks passed on the following fraud allegations and related representations, among others, concerning EFCA as they had been represented to him by his source:

- One-third of EFCA's insurance business was fake "Y" business which Art Lewis had placed on the books of EFCA;
- $10,000 policies were issued and were shown on the books as $25,000 policies which were then co-insured;
- In order to justify the fake business, fictitious records were created to reflect the deaths of policy-holders;
- Insurance policies were given to employees free of premiums in order to overstate EFCA's business;
- Lapsed policies were being co-insured;
- In 1970, one-third of the business was fake;
- The fictitious insurance business was handled according to actuarial tables;
- Micky Sultan, head of electronic data processing, Art Lewis and Jim Smith, the actuary and executive vice president, were very involved in the fake business at EFCA;

- Notwithstanding the supposed increase in business, not enough was being done to sustain the number of salespeople;
- Between December 15 and December 31, the books were falsified by doubling the business;
- Ranger National had reinsured $3 to $6 million of the fake business ($1.7 million in 1971). Eighteen different insurance companies had reinsured the fake "Y" business;
- $5 million of EFCA's assets were fake certificates of deposit;
- Dave Capo and Micky Sultan, EFCA accountants, created the $5 million of fake certificates of deposit which were included in EFCA's assets;
- Six people, including Dirks's source, had left the company within the last thirty days because of pressure put on them to sign false statements and to engage in improper accounting;
- EFCA was attempting to bleed Bankers National, and certain people left Bankers National because they had refused to sign its financial statements;
- The source felt his life was in danger;
- The source had left Bankers National three weeks prior to Courtney's meeting with Dirks on March 13, because he would not go along with the EFCA fraud;
- Stanley Goldblum, Fred Levin and Jim Smith thought

like crooks;

- Lyle Fisher and Gene Tibide [sic ; Thibodeau], employees of EFCA, would talk about what was going on at EFCA;
- Lewis and Edens, EFCA's CPA and life insurance accountants, were creating fake assets by falsifying bank statements;
- The accounting firm of Wolfson, Weiner had shown in EFCA's 1971 convention statement assets of $5 million, which, in fact, were fictitious. This fictitious figure amounted to ten per cent of EFCA's total assets;
- Sol Block of Wolfson, Weiner [EFCA's accountants] was being paid off. His bags were packed and he was ready to go to Rio;
- EFCA would instruct employees as to how to respond to confirmation letters sent by outside accountants who were auditing the insurance business,in order to mislead the accountants; for example, on December 20, 1972, a vice president and treasurer had had statements of the funded loan account sent to his home address;
- When an insurance department examined the insurance policy files, they would be given 50 actual files and the conspirators would create another 50 more to support the false policies;

- Art Lewis of EFCA would produce one of four ledgers depending on who would be seeing them, e.g. outside auditors;
- Haskins & Sells dropped the account because they did not like what was going on at EFCA;
- Although Stanley Goldblum said EFCA was a 15 per cent growth company, the actual rate of growth was not close to that;
- EFCA officers were selling EFCA stock all the time. Stanley Goldblum had been selling for the last six months, as was Fred Levin and Edens;
- A co-insurer had rejected a block of policies submitted through Bankers National, which later had to be replaced with high quality good business. This block had been written by EFCA [EFLIC];
- Art Lewis of EFCA was trying to get names of people at Bankers National who had refused to involve that company in the fraud; and
- EFCA was trying to seize control of Bankers National in order to overstate earnings.

Dirks related that his source had said that the insurance business had always enjoyed a reputation for integrity and that that was the key to the insurance business, and it was for this reason that he wanted to expose what was going on at EFCA. Dirks advised that his source had not previously

known Dirks but that "some other guy" had referred him to Dirks as an analyst knowledgeable in the insurance business. Courtney concluded Dirks had spent quite a few hours with his source based on the extensive notes Dirks had taken and which he referred to in the course of his conversation with Courtney. From the conversation Courtney got the impression that Dirks would be visiting EFCA soon and that there would be other people also who would be hearing the fraud allegations as Dirks had relayed them to him.

Dirks asked whether Courtney wanted to meet Dirks's source, but Courtney declined. The Dirks-Gorrelick-Courtney discussion lasted about an hour and a half.

On the morning of March 13 when Courtney met with Dirks and Gorrelick in New York City, at the III offices in Boston Zukowski and Wise related to Baker, Murphy, Fuss, and Moore the gist of what they knew of the Dirks call of the evening before and of Courtney's desires with respect to the EFCA holdings. Zukowski reported that Dirks's source strongly implied the alleged fraudulent practices were still continuing. Zukowski also reported the check with Haskins & Sells.

As already noted, the proposed sale of EFCA securities in client accounts that Courtney managed was vetoed by Baker, Murphy, and Fuss, and Wise had telephoned Courtney that information just before Courtney's meeting with Dirks and Gorrelick.

The vetoes were prompted essentially by the belief on the part of those who vetoed that Courtney was acting precipitously because in their view, as a minimum, III ought first to do some checking into the matter to determine whether the scheme reported by Dirks was even possible, and, secondly, by their concern, first voiced by Baker, that a check should first be made with III's outside legal counsel for an opinion whether the information received from Dirks constituted inside information such as would preclude their selling on the basis of it without proper prior disclosure.

Regarding the second concern, it was agreed that Murphy should call counsel because he, of those available, had had most contact with III's outside counsel. After the general discussion among the portfolio managers and others was concluded, Murphy obtained additional details from Zukowski concerning the Dirks call of the prior evening in preparation for talking to counsel. Between 10:00 and 11:00 a.m. Murphy called Donald J. Evans, of Goodwin, Procter & Hoar, III's outside counsel.

In a telephone conversation lasting about 15 minutes, Murphy advised Evans that III had received a call from a broker who had been approached by an unidentified and apparently disgruntled ex-employee of EFCA who had left the firm about 3 years earlier and who had alleged that EFCA's earnings had in the past been inflated by the creation of fictitious or bogus insurance policies that were then reinsured or co-insured

by other life insurance companies and that earnings had somehow been transferred among EFCA subsidiaries to boost EFCA's reported earnings. Murphy indicated that the ex-employee had been employed by EFCA in 1969 and that he had left in early 1970, and Evans understood that the allegations of wrongdoing all related to that past period and did not involve continuing wrongdoing. The two of them discussed how the bogus insurance scheme could have been made to work from an accounting standpoint to increase EFCA's reported earnings, and neither of them appeared to have a clear conception of the mechanics of how such a scheme would be feasible or could be successfully carried off. Murphy asked two questions : (1) whether III had an inside - information problem and (2) what steps III could properly take to investigate the rumors. On the basis of the data he had been furnished, Evans orally advised that in his view III was not in possession of material, inside information and that III would be free to investigate or examine all publicly available information regarding EFCA. He specifically cautioned Murphy, however, about not contacting the company, EFCA, either directly <u>or</u> <u>indirectly</u>, to seek confirmation or denial of the allegations.

Sometime after the results of this consultation with counsel had been conveyed to other portfolio managers by Murphy, Baker in the afternoon of March 13th called Courtney

in New York City to advise him that the vetoes of his proposed sales of EFCA holdings out of accounts managed by Courtney had been withdrawn. Earlier in the day, but after Courtney's meeting with Dirks and Gorrelick, Zukowski had called Courtney, in view of the uncertainties caused by Wise's "insisting" that Moore, the trader, proceed with Courtney's sell orders notwithstanding the vetoes by three portfolio managers, to advise Courtney that the others were still adhering to their vetoes. In response to each of the two calls, Courtney told first Zukowski and later Baker to hold up on his sell orders and that he would take up the whole matter when he returned to the office the next morning. As he testified at the hearing, Courtney had concluded that he didn't want to impose his will on the others and felt he could better bring them around to his view that all EFCA holdings should be liquidated in a face-to-face meeting.

Early in the afternoon of March 13 Zukowski returned Dirks's call of 9:15 a.m. The call lasted 20 to 30 minutes; Gorrelick was also on the line with Dirks. A number of matters were discussed. Dirks reported that he had had a phone conversation with a Mr. Balint, the "head man" at Haskins & Sells, former auditors of EFLIC. Dirks reported he detected a note of concern in the tone of Balint's responses, though not evidenced in anything specific that was said. Dirks also

provided Zukowski with EFCA's 1972 earnings figures. In addition, there was fairly extended discussion among the three of them as to whether it would be possible to carry out the purported scheme without having it all collapse like a typical Ponzi scheme. In addition, Dirks mentioned a particular purportedly forged certificate of deposit (he had mentioned there were 4 or 5 such the day before).

On Wednesday, March 14, at the regular meeting of III portfolio managers, attended by Courtney, Zukowski, Murphy, Baker, Fuss and Moore, Courtney took a few minutes at the outset to summarize his discussion of the previous day in New York City with Dirks and Gorrelick.

After Courtney's brief report Baker, Murphy, and Fuss reaffirmed their previous-day withdrawals of their vetoes of Courtney's proposed sales of EFCA securities out of accounts managed by him. At Baker's suggestion, Courtney as president of III called attorney Evans ostensibly to update him and to recheck the legal advice Murphy had been given. In a short (about 5 minutes) telephone conversation Courtney reviewed his understanding of what Murphy had conveyed to Evans and Evans's advice and guidelines. Evans confirmed that that had been his advice based on the information given by Murphy. Courtney offered the view that he didn't think there was an inside-information problem either. Evans reconfirmed his opinion and advice. This was the last

conversation Evans had with anyone at III during the relevant period concerning any rumor of fraud at EFCA.

Courtney had not in fact "updated" Evans on the matter at hand. He did not inform Evans of his extended face-to-face meeting with Dirks and Gorrelick the day before or identify the two. Nor, of course, did he convey to Evans any of the substance of that discussion. Neither was Evans told of the March 13 phone call between Zukowski and Dirks, nor any of its content. Additionally, some of the III personnel had on March 13, after receiving Evans's opinion, commenced "checking" the possibilities that the Dirks story could be true with a variety of sources. The fact of these contacts and their results were not conveyed to Evans by Courtney on March 14th or at any later relevant date by anyone as the "checking" process was continued by III personnel.

On March 14th, at Courtney's direction, Zukowski called Dirks to tell him that Dirks's impending trip to Los Angeles to visit the EFCA offices should not be considered to be on behalf of III and to warn him that in III's view Dirks was risking legal liability by spreading the information. Zukowski also advised Dirks of III's check with counsel Evans.

During the morning of March 14 Courtney urged that III liquidate all of its clients' EFCA holdings. Although Dirks had not told him that he or his source would be talking

to others in the investment community about the alleged fraud, Courtney concluded that since Dirks had talked to III he would be talking to others as well and that Dirks's source was probably also disseminating the allegations. The excess of sellers over buyers and the declining price of EFCA stock during the week of March 12th persuaded Courtney that in this posture any rumors or negative uncertainties regarding EFCA would have a heightened adverse impact on the market for its securities. Courtney was gravely concerned that the stock could drop to $10 or lower, given the circumstances and the volatility it had exhibited in the past. He considered that the existence, and probable dissemination, of the Dirks rumor of fraud at EFCA had killed all chance of a rally.

The other portfolio managers, though they had withdrawn their vetoes of Courtney's proposed sales of EFCA holdings in accounts managed by him, were not ready to liquidate. They wanted to continue the process of checking that they had begun on March 13th; for the most part they still entertained beliefs or at least hopes that EFCA stock would rally.

Late in the day on March 14 Courtney directed Moore to proceed with the sale of the EFCA securities in the accounts he managed. On March 15 III sold into the market 36,500 shares of EFCA stock held in such accounts. The shares were

sold through Goldman, Sachs to various other brokers and to their customers for proceeds of approximately $942,795. On March 16 III sold $300,000 face amount of EFCA debentures for client accounts managed by Courtney for proceeds of approximately $260,133.

On March 15 Zukowski submitted a Brokerage Request form recommending that III direct $4,000 to $5,000 in commission business to Dirks's firm, Delafield Childs. The reason set forth on the form was "[i]nsurance company reports and recommendations." A commission of $3,956.20 was generated for Delafield Childs pursuant to Zukowski's recommendation.

On March 15 Moore told the III portfolio managers that a trader at Delafield Childs had told him that he understood that Dirks had talked to a New York bank about the allegations regarding EFCA. On Friday, March 16, Moore advised some of the III portfolio managers that he had heard via the "trader grapevine" that a large New York City bank had been seeking a buyer for a 100,000 share block of EFCA stock. On Monday, March 19, III learned that a 100,000 share block of EFCA traded that day[15/] and that EFCA stock had declined in price in heavy trading.

These developments concerned Zukowski and others at III; they indicated to Zukowski that the Dirks-reported information regarding EFCA was spreading via the traders' grapevine and that that could be "deadly." At Zukowski's

15/ The sale, by Bankers Trust, actually involved only 99,200 shares.

suggestion, Courtney emphatically urged Murphy, on some of whose accounts Courtney was co-manager, to dispose of the EFCA holdings in his client accounts.

On March 19 Dirks called Zukowski twice, first at about 2:00 p.m. and later at about 6:00 p.m. In the course of these calls Dirks indicated there might be other people, in California, who were aware of the EFCA fraud story, including the acquaintance of Dirks who had referred Dirks's source to Dirks. Dirks also indicated his source had gone to "a large Eastern authority" with the EFCA fraud allegations. He further told Zukowski he would attempt to get his acquaintance in Los Angeles to speak directly on the phone to people at III. In the later call, Dirks indicated he was altering his earlier plan to go to Los Angeles later in the week, cancelling other business (including travel) engagements, and catching the next available plane to Los Angeles to investigate the EFCA matter further. In the course of the two calls Dirks also indicated he expected to visit the EFCA offices and, either in one of those calls or in a call on the following day, Dirks indicated he had a friend who was a reporter in the San Francisco office of the _Wall Street Journal_ and that he would inform the _Wall Street Journal_ of the EFCA fraud allegations.

At the morning meeting at III on March 20, Murphy advised the others that he had decided the previous evening, at home, to sell the EFCA securities held in client accounts managed by him. In reaching that conclusion, one of the factors he considered was his awareness that the Dirks story regarding alleged fraud at EFCA was circulating in the investment community, a fact which would make any EFCA rally very unlikely and further price deterioration in the stock very likely. He was also concerned that if Dirks reported to III information gleaned from a visit to EFCA offices, III might be breaching the "guidelines" established by Evans's legal advice. Murphy recommended that Baker and Fuss also sell out their clients, feeling that a block sale was the only equitable way to do it since so many III clients held EFCA securities. But Baker and Fuss were not yet ready to act, so Murphy deferred implementing his decision until the expected call from Dirks from Los Angeles, and that did not occur until after trading had closed.

Dirks called III from Los Angeles at about 3:00 p.m. (EST) on March 20, having taken a "red-eye" flight to Los Angeles the night before. Dirks advised he had spoken with his acquaintance, later identified as Pat Hopper, and that Hopper was willing to talk to III about the EFCA situation. Zukowski and Baker then talked to Hopper on

separate telephone extensions. Hopper said he had left EFCA in 1972. He mentioned Ron Secrist as one of those knowledgeable about the EFCA fraud. In the course of the subsequent conversation it became clear to Baker and Zukowski that Secrist was the man whom Hopper had originally referred to Dirks, i.e. that Secrist was Dirks's original source.

The conversation lasted about 45 minutes. While there were various differences in particulars, the information conveyed by Hopper tended broadly to corroborate what Dirks had said his source, Secrist, had told him. What Hopper related did not in the main purport to be based upon first-hand knowledge, but upon what he had been advised by another or others. He did, however, indicate that he had made his own rough study of insurance policy sales figures from certain branch offices for 1969 and 1970 and had made calculations which indicated to him that the purported annual EFCA sales of insurance were grossly overstated. Baker and Zukowski asked a number of questions, particularly in the area of how co-insurers or re-insurers could be deceived by EFCA. Hopper's response was that the purportedly-available safeguards in the case they were discussing were not adequate to detect phantom insurance. Hopper further indicated that there was another individual at EFCA who was willing to talk about the EFCA fraud even if it meant his going to jail because of his own involvement. Before the close of

the conversation, Dirks indicated that this person, subsequently to be identified as Frank Majerus, was the next individual Dirks would be seeing in the course of his investigation.

After some discussion of the Dirks-Hopper call, Fuss and Baker decided to sell the EFCA securities from client accounts they managed the next day, since, as already noted, trading had closed for the day on the 20th.

Late that evening, March 20, at about 10:00 p.m.(EST), Baker received a telephone call at his home from Dirks. Dirks reported he had been successful in interviewing Majerus, whom he identified as a former comptroller of EFLIC. Dirks recounted the description Majerus had provided about how $4-5 million of fake insurance business at EFLIC worked and how it would show up on the books of EFCA and the report by Majerus that bogus certificates of deposit were deposited in a bank. Dirks also confirmed the identity of Ron Secrist as his original source. Baker then telephoned Fuss at home to tell him, among other things, that Dirks had said he was going to confront EFCA management with the allegations of fraud the next day.

At the morning meeting on the following day, March 21, Baker reported to the other portfolio managers the substance of what he had heard in the second call from Dirks on March 20.

Baker, Murphy, and Fuss all indicated they were in agreement that the time had come to liquidate all remaining EFCA securities held in III client accounts. Accordingly, on March 21, a total of 371,500 shares of EFCA were sold through Goldman, Sachs for total proceeds of $7,117,157. In addition, III sold to Goldman, Sachs $575,000 face amount of convertible EFCA debentures for total proceeds of $436,328. In making these sales III did not disclose its information concerning the allegations of fraud at EFCA nor had it done so at the time of its earlier EFCA sales on March 15 and 16. Indeed, Moore, on March 21, in response to a question from the Goldman, Sachs trader, who had noted heavy trading that morning in EFCA securities, as to whether Moore knew anything about EFCA, replied that he did not. Moore justified this negative reply in his own mind on the grounds that (a) he had no first-hand knowledge of the fraud allegations and (b) ever since the first telephone call from Dirks on March 12, Moore had scrupulously avoided passing on to traders with whom he dealt any of the information that was coming in to III about alleged fraud at EFCA because he realized that such rumors would "spread like wildfire" within the investment community and could cause grave damage to EFCA. In his view, he simply adhered to that policy when the EFCA sales out of III accounts were being effected.

Between the time of Dirks's first phone call to III on March 12 and the sale of all EFCA holdings on March 21, the portfolio managers and Wise did a substantial amount of "checking" in an effort to confirm or disprove the allegations of fraud at EFCA that they were hearing. These checks included telephone conversations with a number of insurance companies that co-insured or re-insured EFCA policies, some insurance companies that were not so involved with EFCA,[16/] some calls to broker-dealers and analysts familiar with EFCA, and examination and discussion of EFCA filings available at III including a convention statement filed by Bankers National. A particular focus of the inquiry was to determine whether the kind of fraud being alleged was possible or feasible in light of procedures the co-insurers or re-insurers were following and in light of the other entities that would have to be deceived. The results of these checks were mixed and inconclusive, e.g. one re-insurer reported they had a "foolproof" system whereas another described a somewhat "gentlemanly" arrangement under which Wise concluded deception of the re-insurer was possible. While Zukowski, Baker, and Murphy testified that they felt

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16/ Murphy did not contact any insurance companies, and Courtney declined to participate in any further checking after EFCA securities had been sold out of accounts managed by him.

there was no more than a 5% to 10% likelihood that the reports of significant fraud at EFCA were true, the net result of all the checking done by III was that the allegations being related by Dirks could neither be confirmed nor disproved. Meanwhile, Dirks continued to persist in his investigation during the period, to the point of cancelling other engagements and flying out to Los Angeles to interview other former EFCA employees who might confirm or refute the Secrist allegations. Dirks made some 7-10 phone calls in the period to Zukowski and others at III. From his prior association with Dirks, Zukowski knew that Dirks was persistent and highly motivated -- once he "sunk his teeth" into something he stuck with it. During this period, III became increasingly aware that the Dirks story about EFCA was getting around and that it was having a sharply negative impact on the market for EFCA stock. Given Dirks's continuing investigation, things could only get worse in terms of the price impact on EFCA stock, absent a conclusive refutation of the rumors, which in the nature of things wasn't likely in the short term.

Subsequent to the sale of EFCA securities by III on March 21, a number of events occurred that bear on the motivation for and circumstances that prompted such sales.

In a telephone conversation with Dirks on the afternoon of March 21, Zukowski told Dirks that III had sold its EFCA client positions and that III would give him $25,000 in commission

business regardless of how the EFCA matter turned out. Courtney and the other portfolio managers had concurred in the proposal and before year's end III directed over $20,000 17/ in commission business to Delafield Childs.

Between March 23 and March 26, III personnel discussed with personnel at Respondent Bristol & Co. the nature of the allegations regarding fraud at EFCA and referred them to Dirks. These circumstances are discussed in greater detail below in connection with the discussion regarding Bristol & Co.'s receipt of information concerning the alleged fraud.

On March 29 Courtney discussed the reasons for III's sale of EFCA securities with William Wolbach, president of TBC and director of III. Courtney reported that III had "... received disquieting information from the broker concerning potential adverse developments affecting the company." Courtney also reported that he had checked with Don Evans to make sure they had no "insider information" problems and that the information had come "... from a broker who received it from 'a fellow who had been recently fired by the company ." (emphasis added).

17/ See the finding above respecting prior commission business in the amount of $3,956.20 directed to Delafield Childs after the sales of EFCA from Courtney-managed client accounts.

In connection with its receipt of information from Dirks and its subsequent sale of clients' EFCA securities, III used or caused to be used the mails and means and instruments and instrumentalities of transportation and communication in interstate commerce and the facilities of a national securities exchange, i.e., long distance telephone lines during conversations with Dirks and others and with Goldman, Sachs, a member firm of the New York Stock Exchange, through which firm the EFCA securities were sold using the facilities of that Exchange.

Bristol & Co.

On March 22, 1973, John Bristol was told by a salesman and longtime friend at Goldman, Sachs that an unspecified affiliate of Bristol & Co. had sold a large block of EFCA stock on March 21. The friend felt impelled to tell him this because he was aware that Bristol was in the process of acquiring more EFCA stock for a client.

Having been unsuccessful in reaching either Wolbach or Garrick of TBC on the afternoon of March 22 and again in the morning of March 23, Bristol called Courtney, having surmised correctly that III was the affiliate that had traded the large EFCA block. Courtney stated III had been informed of allegations of phantom insurance at EFCA and had become concerned about the existence of the reports.

After a brief conversation, Courtney suggested Bristol talk to Baker, who could better explain the reasons for III's EFCA sales on March 21st. After the call had been turned over to Baker, he talked briefly to Bristol and thereafter to Lee T. Smith, then Bristol & Co.'s president, whom Bristol regarded as more knowledgeable about insurance companies than he (Bristol) was.

In talking to Smith, Baker identified Dirks as the person who had related the allegations to III and said that Dirks had stated his source was a former employee of EFCA. Baker related to Smith the substance of the Dirks-reported allegations, i.e. co-insurance of phantom insurance policies by EFLIC, fabricated certificates of deposit by EFCA, and manipulation of Bankers National earnings statements.

Baker also advised Smith of the substance of the circumstances surrounding III's having gotten an oral legal opinion and guidelines from Evans, and of the "checking" that III personnel had done thereafter.

On March 23 Bristol and Smith discussed the latter's telephone conversation with Baker. They also discussed a memorandum from Oppenheimer & Co. prepared by Donald Kramer that had been received in the morning mail on that day, which reported that an analyst was reporting accounting irregularities at an EFCA subsidiary and that EFCA management had denied any such irregularities. On the afternoon of March 23 Smith called Kramer, who dismissed as untrue the allegations

reported by Dirks. Smith also talked to other insurance analysts in an effort to confirm or refute the fraud allegations. Later that afternoon Bristol and Smith called EFCA's executive vice presidents Yura Arkus-Duntov and Fred Levin in New York City, both of whom denied there was any substance to the phantom-insurance rumors.

About the time that Bristol on the morning of Monday, March 26, was in the process of calling a number of advisory clients to obtain their consents to sell their EFCA holdings, Smith received a telephone call from Baker of III, who suggested to Smith that it would be well for Bristol & Co. personnel to speak directly to Dirks in California, as III personnel had done.[18/]

Beginning about 9:25 a.m. on March 26th, Bristol and Smith commenced about a 10-minute phone call to Dirks in California, advising Dirks that they were calling at the suggestion of Baker of III. Dirks reported that he had been talking to various former employees of EFCA out in California over the weekend and that "what he had heard was not good." Bristol testified (R. 4932):

> He said if he were in my position he would sell the stock.
> He said the publicity was going to get -- going to be bad for the company.

Bristol took this to signify that Dirks was adhering to the

18/ Baker had been requested to call Smith or Bristol to make that suggestion in the course of the regular morning meeting of portfolio managers at III on March 26.

information concerning fraud at EFCA that he had previously conveyed to representatives of III. Dirks also mentioned he had been discussing the EFCA allegations with a Wall Street Journal reporter, and Bristol formed the impression that the WSJ would be coming out with an EFCA story that would be unfavorable. Dirks also stated he doubted trading would continue in EFCA stock until the whole matter had been cleared up because he (Dirks) had talked to the former auditors, Haskins & Sells, and had also prevailed upon the former comptroller of EFCA [Majerus], who had talked to Dirks about the alleged fraud, to talk to Haskins & Sells.19/

Bristol was concerned about the allegations of fraud at EFCA as reported by Dirks and was concerned about the fact that Dirks "was calling people and telling them negative stories about the stock." Bristol knew that Dirks's selective dissemination of the allegations of fraud at EFCA would have a negative effect upon the market for its stock. Bristol became concerned about liquidating clients' holdings of EFCA as soon as possible.

19/ Dirks gave Bristol and Smith the phone number of Michael Balint of Haskins & Sells, but Bristol & Co. did not contact Balint or anyone else at Haskins & Sells because of Bristol's concern about coming into possession of inside information.

At about 10:00 a.m. on March 26 Bristol & Co. solicited a bid for 457,000 shares of EFCA common stock from Jay Perry, block trader at Salomon Brothers. Bristol accepted Perry's bid of $17-1/2 (less commissions), representing a discount from the market price of $19.[20/]

The 600 shares of EFCA common stock owned by the Bristol & Co. Employees' Profit-Sharing Plan were sold through Clark, Dodge & Co. for a total price of $10,399.[21/]

Bristol & Co. solicited and accepted Loeb, Rhoades' bid for the block of its clients' EFCA convertible debentures, totaling $200,000 in face amount, at a net price of $149,000.

The sale of the 600 shares of EFCA common stock from the Bristol & Co. Employees' Profit-Sharing Plan settled in due course with Clark, Dodge & Co.

The sales of Bristol & Co.'s clients' EFCA common shares and convertible debentures did not settle. Salomon Brothers refused delivery of the 457,200 shares, alleging that the transaction was void for violating the anti-fraud provisions of the securities laws. Salomon and its customer, Lawton-General Corp., sought declaratory relief in the United States District Court. Bristol & Co. denied

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20/ Subsequently 200 additional shares were discovered in Bristol & Co.'s clients' portfolios and were included in the block bid for by Salomon Brothers.

21/ Bristol made no effort to sell 600 shares of EFCA common owned by members of his family.

Salomon's allegations and counter-claimed, seeking damages for breach of contract. The Loeb, Rhoades transaction remained open.

Despite Salomon Brothers' refusal to accept delivery of Bristol & Co. clients' shares, the normal on-balance clearing and settlement procedures of the Stock Clearing Corporation resulted in settlement and delivery of some 20,000 shares reflecting Bristol & Co.'s March 26, 1973 trade. The record discloses several ultimate purchasers, including Lily Levy and Walter Rogers.22/

In acting to liquidate clients' and the Employees Plan's EFCA holdings, Bristol & Co. failed to disclose the Secrist-Dirks information about alleged fraud at EFCA to Salomon Brothers, Loeb, Rhoades or Clark, Dodge.

While engaged in the foregoing acts and practices, Bristol & Co., directly and indirectly, used the means and instruments and instrumentalities of transportation and communication in interstate commerce, chiefly local and long distance telephone lines (to TBC and III in Boston, Dirks in Los Angeles, among others) and used or caused to be used the facilities of a national securities exchange, namely the New York Stock Exchange, through Salomon Brothers, a member firm.

22/ Official notice is taken of the on-balance clearing procedure, described at Stock Clearing Corporation Rule 8, N.Y.S.E. Guide (CCH) §3308.

The Dreyfus Corporation

On March 21, after Dreyfus had purchased the EFCA debentures on behalf of DSIF, Orphanos, as the in-house insurance company expert, was called into the Dreyfus trading room by DiMartino, Dreyfus's trader, to discuss by telephone with Eugene Mercy of Goldman, Sachs the reasons for the trading weakness of EFCA securites. Mercy told Orphanos that Dirks had a negative story [23/] on EFCA and that Dirks had several reasons for his negative comments. However, Mercy discounted the Dirks story and reported that he, Mercy, had received assurances from Levin, vice president of EFCA, that EFCA management expected to be in contact with Dirks in Los Angeles and was confident they could correct Dirks's "misimpressions."

Thereafter Orphanos called Dirks by telephone and, finding him not in, left word for Dirks to return his call. Dirks did not call back on the 21st.

23/ Mercy said that Dirks had issued a "sell recommendation" and that that was the cause of the stock's weakness. However, there is no other evidence in the record that Dirks issued any formal or informal sell recommendation or that, up to that point, he had advised or suggested to anyone that the stock be sold. However, as found above, Dirks later, on March 26, suggested to John Bristol that EFCA stock be sold.

Either late on March 21 or on March 22 Quinn learned that DSIF had purchased the EFCA debentures. Quinn told DiMartino he did not believe the debentures were a suitable investment for DSIF in the then market environment. Notwithstanding DiMartino's view that the debentures had so declined in price that they afforded a high yield, it was agreed that the debentures should be sold. Accordingly, before anyone at Dreyfus spoke to Dirks, Dreyfus placed an order with Goldman, Sachs to sell the debentures.

On March 22 Orphanos again called Dirks at Delafield Childs; this time he was given a phone number in Los Angeles where Dirks could be reached. In a conversation lasting about 30 minutes, Dirks mentioned nonrecurring gains in EFCA earnings and two or three other matters that might reflect adversely on EFCA's management or its future prospects, but none of which involved reports of bogus insurance or forged certificates of deposit. 24/

On March 23 Quinn took a call from Dirks. Dirks initiated this call to Dreyfus because he had ascertained in the interim through Vicker's publication or somehow that Dreyfus clients had EFCA holdings. Dirks now told Quinn that his source, whom he identified as a former employee of EFCA, reported that EFLIC had put hundreds of millions of dollars of bogus insurance representing tens of thousands

24/ In the context of this proceeding reports of this kind came to be known as the "soft story" in contrast to the "hard story" reports of widespread fraud involving bogus insurance, forged certificates of deposit, and related details.

of fictitious policies on its books, had fraudulently reinsured the bogus insurance, and had issued phony death certificates as part of the scheme. Dirks also advised Quinn that he had passed on this information to five or six institutional investors. Quinn formed the belief that Dirks believed the reports he conveyed regarding EFCA were true.

Quinn called Orphanos at his home and asked him to follow up with Dirks to get further details, and perhaps more understanding, of the alleged fraud in view of Orphanos's greater expertise respecting insurance companies. Quinn and Orphanos agreed to be in touch again over the weekend prior to Quinn's expected arrival in Los Angeles on other business, at which time he would see Dirks.

Quinn then went into the Dreyfus trading room to ascertain whether the sell order placed the previous day for the debentures had been executed or not. Quinn told DiMartino that he had heard some wild allegations about Equity Funding. DiMartino either was on the direct wire to Goldman, Sachs or picked it up and asked Quinn to relate the information to Mercy of Goldman, Sachs. Mercy told Quinn the debentures had not been sold yet, said the market for EFCA was unsettled, and conveyed the impression that the debentures could be sold only at a deep discount.

Quinn conveyed to Mercy the substance of the fraud allegations respecting EFCA that he had heard from Dirks. He did so because he was perplexed and confused by what he had heard from Dirks, was concerned about his clients' EFCA holdings, and hoped that perhaps Mercy, representing a block trader, could shed some light on the subject.

Mercy dismissed the allegations, indicating he was a personal friend of EFCA's vice president Levin, in whose personal honesty and integrity he had great faith. He said he had been aware of "rumors" regarding EFCA and that that accounted for the low price at which Dreyfus had been able to pick up the EFCA debentures on March 21. Mercy, learning that Quinn intended to be in Los Angeles shortly, urged him to check out the rumors personally with EFCA management.

Quinn decided against selling the debentures at a discount, suspended the sell order, and decided to suspend judgment pending further checking by Dreyfus, including his impending business trip to Los Angeles at which time he would talk in person to Dirks and possibly visit EFCA management.

Shortly thereafter Quinn received a call from Levin, who happened to be in New York City on March 23, and Arkus-Duntov from EFCA's New York office. They stated they understood Quinn had heard some rumors regarding

EFCA. Quinn related the substance of what he had heard from Dirks. Levin dismissed the allegations as preposterous and presented arguments to the effect that it would be impossible for such things to occur undetected.

During the afternoon of March 23, Orphanos conversed by phone with Dirks concerning the allegations of fraud at EFCA. Included in what was conveyed to Orphanos were allegations that one third of all insurance in force at EFLIC was fictitious and that Don Goff, a current employee of EFCA, had confirmed the fraud.

In a subsequent phone conversation the next day, March 24, a Saturday, Orphanos got from Dirks the names and positions of various persons with whom Dirks had spoken in the course of his continuing investigation, including the names and phone numbers of at least four former EFCA or EFLIC employees: Secrist, Hopper, Gene Thibodeau, and Brian Tickler. Dirks also indicated he planned to speak shortly to Michael Balint of Haskins & Sells, EFLIC's former auditors, and that he doubted EFCA would open for trading thereafter.

Over the March 24-25 weekend Orphanos spoke by telephone with Secrist for 44 minutes and more briefly with Thibodeau and Tickler. Secrist talked freely, confirming in general the story as Dirks had given it and

adding some particularizing detail. Thibodeau spoke, among other things, of special computer tapes accessible only to top EFCA officers, of "Departments 99 and 65" (code terms for the alleged phony insurance operation), and of 20,000 policies that generated neither bills nor routine correspondence. Tickler showed a reluctance to talk about particulars over the phone but implied that there was a great deal going on at EFCA that wasn't right.

In phone conversations on March 24-25 Orphanos conveyed to Quinn the gist of what he had heard from Secrist, Thibodeau and Tickler, and added his own impression that something was seriously wrong at EFCA. Quinn instructed Orphanos to brief Peter Vlachos, who would be the only Dreyfus portfolio official present at the New York offices on Monday, March 26, empowered to authorize a sale. Orphanos did so. Quinn and Orphanos also arranged on the 25th to speak again on the morning of the 26th, by which time Quinn would have met with Dirks.

Dirks and Quinn met on the evening of March 25 in the latter's hotel room, for about 15 minutes. Dirks carried a satchel of papers, including copious notes of the interviews he had conducted. He told Quinn that he had contacted additional employees or former employees of EFCA since their last conversation and that they had corroborated information he had gotten earlier. Dirks

stated he had begun to fear for his personal safety to the point that he moved to a different hotel after having been advised to be cautious by a representative of EFLIC's former auditors. Dirks indicated to Quinn his understanding that an "unfunded receivables" account was a key element in disguising EFCA's asset shortages.

Dirks reported to Quinn that he had arranged for Majerus and Hopper to meet with William Blundell, a Wall Street Journal reporter to whom Dirks had told his EFCA story. Dirks also told Quinn that he had requested Majerus, the former comptroller at EFLIC, to tell his story to a Mr. Balint, the partner in charge at Haskins & Sells, EFLIC's former auditors. Dirks also said he had subsequently learned from Balint that Majerus had called him. Dirks told Quinn that he regarded this as significant because Balint knew Majerus well and that this might prompt Haskins & Sells to "do something".

By the conclusion of his meeting with Dirks, Quinn realized that the story about fraud at EFCA had been "embellished" (i.e. elaborated), and he felt that "the web was spreading." Orphanos, his in-house expert, was crediting the information. Quinn's testimony that he did not believe "totally" in Dirks indicates that at the very least he believed at that point that there was a good chance that the Dirks allegations, as reported by him and "confirmed", in substance, by others, were true.

Early on Monday, March 26, before the market opened, Orphanos and Vlachos called Quinn. Quinn indicated he had seen a large amount of paperwork by Dirks, and that nothing he saw or heard was inconsistent with what Quinn had originally heard from Dirks about fraud at EFCA. Quinn wanted the debenture sell order re-entered. Based on the briefings by Quinn and, earlier, Orphanos, Vlachos concurred and agreed to authorize the sale of the debentures. Having been unable to disprove the allegations of fraud at EFCA after extensive checking (to the contrary, all the checking results were consistent with and therefore tended to corroborate the allegations), Dreyfus personnel concluded that they should act on the information they had received about fraud at EFCA by selling the debentures. As Orphanos put it (R. 476):

> Sale of the security is . . . if you can't satisfy your doubts completely, is a normal investment conclusion.

Quinn indicated to Vlachos his view that their boss, Howard Stein, then away in Europe, should be advised of the EFCA matter, particularly in light of the EFCA common stock holdings in the DF account.

Shortly after speaking with Quinn, Vlachos reactivated Dreyfus's sell order for DSIF's $500,000 face amount of EFCA convertible debentures without substantive discussion

of EFCA with anyone at Goldman, Sachs. Goldman, Sachs, acting as principal, purchased the debentures for net proceeds of approximately $362,933.

In effecting its sale of the EFCA debentures on March 26, 1973, Dreyfus personnel acting on behalf of DSIF used or caused to be used the mails and telephone. The telephone was also used in conversations with Dirks and others and among Dreyfus personnel.

Manning & Napier

On March 21, 1973, Manning telephoned Oppenheimer & Co., a broker-dealer with which Manning & Napier ("M & N") had in the past transacted some business, seeking information concerning EFCA. He first spoke to Neil Weisman, with whom he had had contacts before. Weisman told Manning there was a rumor out concerning EFCA and referred him to Donald Kramer, an insurance analyst and partner at Oppenheimer & Co., who, Weisman indicated, was more knowledgeable about the matter.

Either Weisman or Kramer identified Dirks as the source of the rumor regarding EFCA, and indicated Dirks's employer was Delafield Childs.

Kramer told Manning that the rumor involved questionable accounting practices but that he placed no credence in the rumor. Manning testified that Kramer told him on March 21 that the rumor involved allegations of bogus

insurance policies and of a change in accountants at EFCA. The testimony by Manning about having been told of bogus insurance at EFCA is not credited, for a number of reasons. Firstly, in testifying at the hearing Manning exhibited considerable uncertainty as to what was said in his first conversation with Kramer, on March 21, as contrasted with what was said in his second telephone conversation with Kramer, on March 26, after Manning had spoken on the phone with Dirks. Secondly, Kramer testified positively and persuasively that he did not mention on the 21st anything to Manning about bogus or fictitous insurance policies at EFCA and that in fact he had as of that date not heard any such rumor. Thirdly, there is no other evidence establishing that Kramer on the 21st was aware that the rumor regarding EFCA involved bogus insurance. Lastly, in a memorandum dated March 21, 1973, Kramer, in referring to and discounting a rumor regarding EFCA, stated that "- - - a small brokerage firm following Equity Funding's stock questioned the accounting. Management has denied that there are any accounting changes."

After his conversations with Weisman and Kramer on March 21, Manning attempted to reach Dirks; he was told by Delafield Childs personnel that Dirks was not in but would return the call.

During "pub night" on Friday, March 23, Manning told Reeves that he was "getting out" of Equity Funding.

Dirks did not return Manning's call until the morning of Monday, March 26, when he called from Los Angeles. The call lasted about 35 minutes. Manning indicated to Dirks that they had a position in EFCA and had heard that Dirks had some information regarding EFCA. Dirks told him that EFCA had written bogus insurance policies and that the source of this information was a former EFCA employee who had been in a position to know of the fraud. Dirks also gave Manning the impression that he was continuing to investigate the allegations. In addition, Dirks reported that top management at EFCA was reportedly involved in the bogus insurance fraud. This is clear from Manning's testimony that during his later call to Kramer, also on March 26, during which Manning was trying to get Kramer's reactions to what Dirks had reported, Kramer expressed the strong conviction that top management at EFCA could not be involved in any such scheme.

Beyond that it is not clear what if any additional information Dirks gave Manning about the fraud at EFCA as he then understood it to be during their 35-minute phone conversation. While it seems likely that Dirks gave additional details in the course of a conversation

of that length, given the disposition of Dirks to speak freely about his investigation to anyone he knew had holdings in or "an interest in" EFCA, this is not established by "clear and convincing" evidence and accordingly no finding is made on this point.

On the morning of March 26, after his call to Dirks, Manning called Kramer. In this second conversation, according to Manning, he related to Kramer the gist of what he had learned from Dirks. Kramer adhered to his views that EFCA was all right, and, as noted above, expressed strongly the view that top management at EFCA could not be involved in fraud.

On March 26, directly after Manning had talked to Dirks and then Kramer, M & N liquidated all EFCA securities in its client accounts (5,450 shares of EFCA common stock for net proceeds of $89,952) between noon and 1:00 p.m.

That Manning acted with unusual dispatch in selling EFCA holdings following his two phone conversations is evident from the fact that he had a clerical employee who did not customarily execute securities transactions make the sales rather than awaiting the return at 1:00 p.m. from lunch of his assistant Calvert,[25/] who normally executed securities transactions for the firm.

25/ The two employees had switched their lunch hours that day.

At the time he directed sale of the EFCA stock, Manning was convinced that selective dissemination of the Dirks story regarding EFCA was driving the price of the stock down. (R. 3566). This,in turn, made Manning more disposed to credit the allegations of fraud at EFCA as conveyed by Dirks. In prior sworn testimony given before an SEC investigating attorney on January 25, 1974, Manning testified in part as follows (R. 3559-60):

> I just have to say that if the market conditions were different, possibly if I didn't have the attitude that I did, that I might have ignored him. [Dirks]
>
> * * *
>
> But the stock had come down to the point where I was panicky about it.
>
> It was dropping rapidly.
>
> . . . I was emotional at that time and I was disturbed by the price and confused by what a couple of so-called experts were giving me on both sides of the story.

When the EFCA stock was sold by M & N the information Manning had obtained from Dirks was not communicated to the brokers with whom the sell orders were placed. Nor was there any communication to them of the substance of Manning's conversations with Kramer.

In connection with the sales of its clients' EFCA holdings, M & N used or caused to be used the mails and means and instruments and instrumentalities of transportation and communication in interstate commerce and the facilities of a national securities exchange. M & N used the telephone

in seeking and receiving the Dirks information about EFCA and in connection with Manning's conversations with Kramer.

Tomlin, Zimmerman & Parmelee, Inc.

In March, 1973, TZP maintained direct, open telephone lines to a number of broker-dealers with whom it did substantial business, including Goldman, Sachs & Company.

During the week of March 12 Edward Spiegel, a registered representative at Goldman, Sachs, who serviced the TZP account, called Tomlin to advise him that Goldman, Sachs had traded a large block of EFCA stock at a sharp discount. He said he didn't know why, but would attempt to find out. On Friday, March 16, and again on Monday, March 19, Spiegel told Tomlin he had not learned anything.

On March 20 Spiegel called Tomlin and Zimmerman to relate that he had heard "third or fourth hand" that Dirks had a negative story about EFCA. Spiegel did not state the substance of the story, and there is nothing in the record to indicate whether he was aware of it. Thereafter Zimmerman placed a call to Delafield Childs on March 20th, where he learned from an associate of Dirks, Allen Gorrelick, that Dirks was not in the office but would be calling in.

That same day Dirks returned Zimmerman's call and talked to Tomlin and Zimmerman for about 20 to 30 minutes.

Tomlin remained on the phone during the entire conversation and Zimmerman was on the phone for parts of it. In the course of the conversation it became clear that Dirks was calling from California.

During this conversation Dirks indicated that he had questions about a possible change in accounting for dividends to participating policyholders at Bankers National which could have inflated EFCA's 1972 earnings. Dirks also reported that a number of executive employees had left Bankers National recently, to which Tomlin responded that this was well known and not unexpected when there is an acquisition. The Bankers National convention statement and EFCA's financial statements generally were discussed in this conversation. Tomlin was favorably disposed towards EFCA and attempted to point out positive things about the company.

There was no mention of fictitious insurance or of fraud at EFCA or any of its subsisiaries in the course of this conversation.

Dirks indicated he would be meeting with EFCA management personnel and asked if Tomlin or Zimmerman had any questions they wanted him to explore. One or the other suggested that Dirks attempt to get clarification of the Bankers National "numbers."

Following this conversation and prior to their next conversation with Dirks, on March 22, Tomlin called Don

Kramer at Oppenheimer & Co., Edus Warren at Spencer Trask and a Mr. Jones at Edwards & Hanley, and received confirming views that there was nothing wrong with EFCA's accounting and that the stock was a good investment. Prior to March 20, Tomlin had spoken to Edward MacElaney at Conning & Co., who also favored EFCA.

On March 22 Dirks left a message requesting that Tomlin or Zimmerman return his call, which they did at 3:32 p.m. (EST). Tomlin participated during the entire 39-minute conversation that ensued, whereas Zimmerman was intermittently off the phone.

Dirks reported that he had met with EFCA management and discussed the Bankers National convention statement and Bankers National dividends to participating policyholders. Dirks indicated he was not entirely satisfied with management's explanation of the accounting for dividends to participating policyholders nor sure that he could believe their explanations.

Dirks also said that EFCA was issuing insurance policies to employees free of first-year premiums. Dirks testified that this part of the conversation involved policies issued by EFLIC, whereas Tomlin and Zimmerman testified that they understood Bankers National to be the subsidiary involved. Tomlin attempted to explain to Dirks that this would not be an abnormal practice based

upon his understanding that it was not uncommon in the insurance industry for companies to offer insurance to their employees at a first-year premium that represented the normal first-year premium less what was paid to salesmen the first year and that, since EFCA had a first-year commission to salesmen of 100%, that meant there would be no premium charge to the employee in the first year.

There was also discussion during this conversation in general terms of the value of EFCA as a holding. Tomlin referred to a favorable analysis by Conning & Co. and said EFCA's financial statements showed good insurance sales and earnings.

Either during the conversation on the 20th or the 22nd, Dirks indicated he had been talking to a former employee of Bankers National who had been fired, and Zimmerman testified he understood the former employee to be the source of some of the "rumors" Dirks was conveying.

During the March 22 conversation there was no mention of fraud at EFCA or any of its subsidiaries.

By the time the March 22 conversation with Dirks had occurred, Zimmerman had concluded in his own mind that what Dirks had told TZP he was also telling others.

On the morning of March 23 Charles Boillod, a salesman at Goldman, Sachs, telephoned Zimmerman and told him

that they were in the process of assembling a sizeable block trade of EFCA and expected to trade about 100,000 shares on an "up-tick". Boillod said there was considerable interest in the stock, that they felt its price was bottoming out, and that the projected block trade would pretty much "wash out" the stock, meaning that after a substantial decline in a short period of time in an over-sold stock a large trade such as that contemplated could be expected to relieve the selling pressure and afford a favorable environment for a return to higher price levels.

After discussing the call from Boillod, Tomlin and Zimmerman on March 23 purchased 3,000 shares of EFCA at $19-3/4 as part of a block traded by Goldman, Sachs as agent for both sides. As part of that decision to buy, Tomlin and Zimmerman concluded that the price of the stock was favorable, that the drop in price had been caused in part by the activities of Dirks, and that their conversations with Dirks on March 20 and 22 had served to correct Dirks's "misimpressions" concerning EFCA, so that they could reasonably expect him not to spread any more negative rumors about the stock.

Later in the day on March 23, a Friday, Dirks left a message for Tomlin or Zimmerman to return his call. Tomlin did not return to the office that Friday afternoon, and Zimmerman chose not to return the call.

On Monday, March 26, prior to 10:00 a.m. (EST), Dirks again phoned TZP from Los Angeles, though his call of the previous Friday had not been returned.

Zimmerman took the call and promptly called Tomlin to the phones as well. A sixteen minute conversation among the three men followed.

Dirks told Tomlin and Zimmerman that his source told him there was fictitious insurance on the books of an EFCA insurance subsidiary. Tomlin and Zimmerman testified that the subsidiary referred to was Bankers National; Dirks's testimony, on the other hand, in its overall context, would have to be taken as referring to EFLIC. It is concluded that while Dirks referred to EFLIC, Tomlin and Zimmerman mistakenly understood the reference to be to Bankers National, perhaps because much of their earlier two discussions had focussed on Bankers National and because Dirks's source for this allegation was identified as a former employee of Bankers National.

Tomlin demanded to know who the source was for this new rumor. Dirks, without identifying him by name, stated that his source was a former employee 26/ of Bankers National who had been fired.

26/ There is evidence in the record that would warrant a conclusion, if the standard of proof being applied were that of "preponderance of the evidence" rather than the "clear and convincing" test, that Dirks identified his sources as former employees of EFCA. Likewise, there is evidence in the record that would warrant a conclusion, under the less demanding standard of proof, that Dirks told Tomlin and Zimmerman on March 26 not only the allegations of fictitious insurance but also in substance the story about fictitious assets and fake death certificates etc., that officers of EFCA were reportedly involved in the fraud, and, in short, the allegations that he, Dirks, was aware of at

Tomlin testified that the amount of reported fictitious insurance was $7,000,000 on the books in 1971. Zimmerman testified to the same figure but was not sure of what year it applied to. Dirks did not refer to a specific figure, but if he had mentioned any figure it would have been about a third of the policies of EFLIC. 27/ It is concluded that somehow Tomlin and Zimmerman erroneously came to understand that the amount of fictitious insurance involved was $7,000,000 face amount.

When Tomlin asked Dirks if he believed allegations of fictitious insurance,he stated that "he might." He stated this view even after he had earlier, as he reported to Tomlin and Zimmerman, confronted EFCA's president Goldblum with the allegations of fraud. Goldblum had flatly denied the allegations and had asked whether Dirks was charging that EFCA was committing fraud. Dirks reported that he had stated to Goldblum that he was not alleging fraud.

Dirks also reported in his March 26 conversation that he had reported the allegation of fictitious insurance to Haskins & Sells, EFLIC's former auditors.

26/ (footnote continued)
that time. (R. 1155). Dirks testified that his testimony at p. 1155 of the transcript represented, in substance, his best recollection of what he told TZP on March 26th. (R. 1917). Later, on recross (R. 1929-31) Dirks testified that in certain particulars his testimony as reported at p. 1155 of the transcript was based upon his ". . . hypothesis in trying to figure out what I would have said at that time and not based on recollection, specific recollection." The findings made herein, are only those that meet the "clear and convincing" standard.

27/ See footnote 26 next above.

Dirks further reported that he had informed EFCA's [and EFLIC's] current auditors, Seidman & Seidman, of the allegation regarding fictitious insurance and had given them a copy of some notes he had taken relative to the matter. Dirks reported that he became very upset when he learned shortly after turning over the notes that Seidman & Seidman had promptly turned over the notes to Goldblum.

Zimmerman testified that some of the time in the conversation on March 26 was spent going over the ground covered in their earlier conversations on March 20 and 22. Tomlin, on the other hand, testified that they did not go over what had previously been covered, nor does Dirks's testimony give any such indication. It is concluded that no significant amount of the March 26 conversation was devoted to reviewing matters covered during the earlier two calls.

Immediately after discussing the implications of their March 26 conversation, Tomlin and Zimmerman decided to sell all EFCA securities held in TZP client accounts.

They were both upset about hearing the fraud allegations from Dirks. Tomlin tended to disbelieve the allegations of fraud and suspected that a bear raid might be in progress. Zimmerman, who had formerly worked at another firm while Dirks was also employed there, felt that Dirks was determined to destroy the stock and that they couldn't tell what kind of a rumor regarding EFCA Dirks would be coming out with next, though he did not attribute any ulterior motives to Dirks's activities.

Tomlin and Zimmerman concluded that Dirks would disseminate the allegation of fictitious insurance to others and that it would get around, and they were concerned about this. They had already concluded that even the "soft story" rumors reported earlier by Dirks had been a factor in depressing the stock of EFCA. They concluded that the further dissemination of the allegations of fictitious insurance at EFCA could only be negative, not positive. They despaired of any hope that the stock would recover--a hope they entertained on the 23rd when they purchased 3,000 additional shares of EFCA. Their concern was heightened by the fact that they were aware that in the past EFCA had reacted strongly to an unfavorable report.

Through March 26 Tomlin and Zimmerman had not heard any report of fictitious insurance at EFCA or any of its subsidiaries from any source other than Dirks.

Prior to the lunch hour on March 26 Zimmerman placed sell orders for all of the EFCA securities held by TZP's clients. These included 26,920 shares of common stock and $60,000 face amount of debentures. 24,500 shares of the stock and all of the debentures were sold through Goldman, Sachs, 200 shares of stock were sold through Stern, Frank and 220 shares through Loeb, Rhoades.

At the time of TZP's sales on March 26, Tomlin and Zimmerman had no knowledge of whether Goldman, Sachs or the other brokers knew of Dirks's report of allegations of fictitious insurance at EFCA.

Before the sale of the EFCA securities held by TZP's clients neither Tomlin nor Zimmerman told any Goldman, Sachs or Stern, Frank or Loeb, Rhoades representative about Dirks's report of allegations of fictitious insurance at EFCA.

After the March 20 and 22 conversations with Dirks, Tomlin had informed Spiegel at Goldman, Sachs of the substance of the conversations; but on March 26 Tomlin made no call to Spiegel, prior to TZP's sales of EFCA securities, even though Spiegel had been the source of TZP's initial information that Dirks had some negative information concerning EFCA.

In connection with the sales of its clients' EFCA holdings, TZP used or caused to be used the mails and means and instruments and instrumentalities of transportation and communication in interstate commerce and the facilities of a national securities exchange.

Raymond L. Dirks

In addition to the findings made above in this part regarding the receipt, investigation, and dissemination of non-public information concerning fraud at Equity Funding by Respondent Raymond L. Dirks in connection with findings made respecting the individual selling respondents, 28/ certain additional findings are necessary with respect to Respondent Dirks as bearing on the charges against him. 29/

28/ Dirks himself did not sell any EFCA securities; the other respondents are sometimes referred to collectively as the "selling respondents". Dirks is charged with having aided and abetted selling respondents in their alleged violations and with having committed violations independently through his alleged "tipping" activities.

29/ See footnote 28 next above.

On March 6, 1973, from "out of the blue" Dirks received a telephone call from Ronald Secrist, who introduced himself as a friend of Patrick Hopper, whom Dirks knew. Secrist further identified himself as a former employee of EFCA or EFLIC and of Bankers National, and said he had some significant information about his former employer that he thought would interest Dirks, e.g. that one-third of EFCA's reported life insurance did not exist, that fake certificates of deposit had been created, and "other sorts of activities that would indicate the Company was doing some mighty unusual things." Dirks agreed to meet with Secrist the next day around noon.

On March 7 Dirks and his associate, Allen Gorrelick, met over lunch with Secrist for about 3-1/2 hours. In substance, the main allegations conveyed by Secrist relevant here were those subsequently reported by Dirks and Gorrelick to III personnel, as found above.

Dirks took extensive notes during the conversation.

Secrist described the origin of the alleged fictitious insurance scheme. He said he understood that when Presidential Life, the predecessor of EFLIC, was acquired Presidential had poor-quality business on its books. Because Fred Levin had managed to reinsure the business at a good price, he was made President of EFLIC. The next year EFCA decided to give its employees insurance without a first-year premium. This created a large block of insurance that was subsequently reinsured.

In 1970, Secrist continued, EFCA at Levin's suggestion embarked on a full-fledged program of totally fictitious insurance in order to sustain EFCA's objectives of 15% compounded growth rate in net earnings. This business, Secrist stated, became the "Y" business, so named by Art Lewis, the EFLIC chief accountant and statistician, because in mathematics "Y" is a symbol for an unknown.

Secrist said he had been told that 1/3 of EFLIC's insurance in force -- 40,000 policies -- was fake and that each of 18 companies with which EFCA reinsured had some of the phony "Y" business.

There was considerable discussion as to how there could be a failure to discover the alleged scheme on the part of the companies reinsuring the fake EFLIC policies. Secrist attributed this to lax procedures on the part of the co-insurers and a tendency to rely too heavily on trust in the insurance industry.

Likewise, there was discussed the question of how the auditors could fail to discover such a scheme. Secrist said that although EFCA had been regularly audited, the audits had not uncovered the alleged fraud. Secrist stated he had been told that the company created fake policy files and that he personally had on one occasion participated in a "party" creating such files. Secrist also stated his understanding

that EFCA supplied the auditors with phony confirmation letters from purported policyholders. Secrist exhibited to Dirks and Gorrelick two examples of such confirmation letters, bearing the names of "Crist" and Secret".

Secrist stated he understood that when necessary as many as 20 phony files would be created overnight, after the auditors had indicated what files they wanted to check, and that these would be complete with medical records and other supporting items.

Secrist also reported his understanding that in order to support the fraud it was necessary to create other phony journals, ledgers, and records and that this included the creation of fictitious bank statements and forged certificates of deposit.

Secrist also told Dirks and Gorrelick he had heard that Sol Block, a C.P.A. with Wolfson, Weiner, the subsidiary of Seidman and Seidman that performed the EFCA [including EFLIC] audits, was actually on the payroll of EFCA and that Block had been "paid off" at the end of 1971.

As to Haskins & Sells, EFLIC's former auditors, Secrist stated he understood that they had been fooled by a number of stratagems employed by Art Lewis and others but that, by the end of the third year of the scheme, they had become very suspicious of EFLIC.

Secrist told Dirks and Gorrelick that he had been told that some people at EFCA had heard of Mafia threats and were inhibited from discussing the fraud.

Secrist told Dirks and Gorrelick that Brian Tickler, a data processing consultant to EFLIC, confirmed the fraud to him. At Dirks's request, Secrist named Lyle Fisher and Gene Thibodeau, who had left the company, as possible further contacts for Dirks. Later in the conversation Secrist gave Dirks additional names of former employees that he said could confirm the fraud and would talk to Dirks: Frank Majerus, Don Goff, Mike Keller, and Pat Hopper.

Secrist also reported that there were stories around the company that the top officers kept a supply of ready cash on hand along with their passports and that they kept their suitcases packed so as to be able to leave the country on a moment's notice "in case this thing blew up."

A considerable part of the conversation involved alleged activities or events or occurrences at or respecting Bankers National, where Secrist had been transferred from EFCA/EFLIC in October, 1971, and to which a number of other EFCA/EFLIC employees had also been transferred. However, those matters are essentially irrelevant to the issues presented in this proceeding. Secrist indicated that while at Bankers National he had continued to discuss "Y business" and related matters at EFCA/EFLIC with employees at Bankers and others.

The interview included the question of Secrist's motivation in coming to Dirks with his story. Secrist asked Dirks to check the information, verify its accuracy, and then dis-

seminate it as widely and quickly as possible. In response to a question from Dirks as to whether Secrist had sold EFCA stock short, Secrist replied that although a friend had suggested that to him he had rejected the proposal out of hand. Secrist said he felt strongly about the reputation of the insurance industry, which he considered to be basically ethical, and he said he thought fraud of this kind had to be exposed.

Dirks asked Secrist for permission to discuss the EFCA fraud allegations with Herbert Lawson, Chief of the San Francisco Bureau of the Wall Street Journal, and Secrist consented.

Secrist indicated he had not gone to the SEC with his allegations about fraud at EFCA because of his understanding that other employees who had done that in this or similar situations had not met with success and had had the confidentiality of their reports breached.

With respect to state departments of insurance, Secrist indicated to Dirks and Gorrelick that Fred Levin of EFCA had formerly worked at the Illinois Insurance Department, that he had heard someone there had been paid off by EFCA, and that, based on what he understood to have been a lack of interest in prior reports of irregularities by others, he had not gone to any state regulatory bodies with his allegations.

After concluding the meeting with Secrist and Gorrelick on the 7th, Dirks left for Philadelphia where he had business appointments and where he remained Thursday and part of Friday, March 8 and 9. Before leaving, he requested Gorrelick to check out with Ron Kehrli, a friend of Gorrelick's who had been with EFCA, the possibility that some confirmation of the fraud could be obtained, as Secrist had suggested, by examination of the sales records of the 200 most productive EFCA salesmen.

Returning to New York City on Friday the 9th, Dirks obtained from his files the convention statements of Bankers National and EFLIC as well as other reports and the most recent prospectus issued by EFCA. He examined these materials over the weekend of March 10 and 11. He found nothing in them that would tend either to confirm or to disprove Secrist's allegations of fraud at EFCA.

Either on Friday, March 9, or Monday, March 12, Gorrelick, acting on Dirks's instructions, called individuals at Bankers National in an attempt to test the Secrist allegations, particularly as they related to alleged events at Bankers National.

On the morning of March 12, a Monday, Dirks attempted to call Herbert Lawson of the Wall Street Journal. Dirks's purpose, as he testified (R. 1249) was as follows:

> Well, I thought that I would try to have somebody who could generate publicity about this investigation it [sic] -- investigate with me or separately and I wanted to give him the allegations by Mr. Secrist in order that he could do something.

Lawson was not available and it was not until later that Dirks

made contact with him.

On the morning of Monday, March 12, Dirks also had a telephone conversation with EFCA's president, Goldblum, using as a pretext for calling the appearance that morning of the EFCA earnings report on the Dow Jones broad tape. The two discussed EFCA's fully diluted earnings, including earnings of EFLIC and Bankers National, which Goldblum reported were up, as well as the number of EFCA's sales agents, but the allegations Dirks had heard from Secrist were not raised. Goldblum invited Dirks to visit EFCA's offices, and they made an appointment for him to do so about March 27-28.

On March 12 Dirks directed his staff to examine Delafield Childs's records to ascertain which clients or potential clients "had an interest" in EFCA. "Having an interest" in a stock was something of a euphemism that clients and analysts employed because of a reluctance on the part of clients or potential clients to disclose specifically whether they held a stock or the extent of their holdings. Nevertheless, based on the nature of the contacts, it was frequently possible for an analyst to surmise that a client or contact held or at least likely held a stock and to have some idea of the probable size of any such holding. Based upon examination of the contact sheets and upon Dirks's specific recollection of an earlier conversation with Zukowski of III, III, Institutional Capital, and the Employee Pension and Profit Sharing Plan of Sears Roebuck were identified as

likely holders of EFCA securities.

Later in the day on March 12, Dirks called Zukowski and there ensued the 40-45 minute conversation among Dirks and his associate Gorrelick in New York and Zukowski and Courtney of III in Boston, during which the former conveyed to the latter essential elements of the Secrist allegations of fraud at EFCA, as found above.

After his conversation with III officials on March 12, Dirks called Haskins & Sells, EFLIC's former auditors, and spoke with Michael Balint, who had been in charge of the EFLIC account. As Dirks reported to III the following day, he detected a note of concern in Balint's reaction to Dirks's call, as found above.

On Tuesday morning, March 13, Dirks and Gorrelick had their meeting with III's president, Courtney, at the Delafield Childs offices in New York, as found above. Dirks "surmised" that III had a substantial position in EFCA based on Courtney's willingness to visit Dirks and Gorrelick at the Delafield Childs offices.

Additional telephone conversations concerning alleged fraud at EFCA occurred on the afternoon of March 13 and on March 14 between Dirks and Zukowski, as found above.

On the afternoon of March 14, Gorrelick advised Dirks that John Buszin, a security analyst at Bankers Trust Company specializing in the insurance industry, had told him that Bankers Trust owned EFCA securities, and raised the question

with Dirks whether they shouldn't convey to Bankers Trust the same information they had conveyed to III regarding allegations of fraud at EFCA. Dirks concluded they should call Buszin, who confirmed that Bankers Trust held EFCA securities and indicated he would like to hear anything Dirks might have to report about EFCA. Dirks concluded he'd rather convey the information in person and therefore arranged to call at Buszin's offices, only a few blocks away, the following day, March 15.

Dirks met as scheduled with Buszin on March 15, and related briefly the central allegations of fraud at EFCA that he had heard from Secrist. After a time Buszin indicated he didn't care to hear any more and that Bankers Trust was going to sell their EFCA holdings. Dirks was "shocked" to hear Buszin announce that intention so abruptly because in his experience such decisions were normally made much more deliberately.

On Monday, March 19, Dirks called Pat Hopper, a former EFCA employee, after having made a prior unsuccessful attempt to locate him in Los Angeles. Dirks sounded out Hopper about the allegations of fraud at EFCA that he had heard from Secrist. Hopper indicated that while he personally had no evidence of fraud at EFCA, he was inclined to give a certain degree of credence to Secrist's allegations.

While he was on the phone with Hopper, Dirks learned that a block of 100,000 EFCA shares traded that day. In light of Buszin's statements on March 15, Dirks concluded the seller was probably Bankers Trust, and he conveyed that belief to Hopper.

On the 19th Dirks also called Secrist. He told him of his conversation with Hopper. In the course of this conversation Dirks learned for the first time that Secrist had reported his allegations to a state insurance department on the East Coast.

In addition, on March 19 Dirks had two more telephone conversations with Zukowski of III, concerning, among other things, Dirks's impending trip to Los Angeles, as found above.

On March 19 Dirks again called Lawson of the <u>Wall Street Journal</u> in San Francisco, Lawson having failed to return Dirks's earlier call. Dirks told Lawson that a former employee of EFCA had alleged that senior officials of EFCA were involved in fraud that included fictitious insurance, death certificates, certificates of deposits, and other assets. Lawson responded that the matter might be turned over to their Los Angeles office. (Under established <u>WSJ</u> procedures, that "story", as William Blundell of the <u>Journal</u> testified, belonged to their Los Angeles office inasmuch as EFCA was located there.) Dirks expected that a highly respected publication like the <u>Wall Street Journal</u> could be

effective in helping him investigate the Secrist allegations and to expose the EFCA fraud if it proved to exist.

On March 19, rather late in the day, Dirks also called Institutional Capital Corp. in Chicago because a review of Delafield Childs'prior-contact sheets indicated that that firm had manifested an interest in EFCA. Dirks first spoke to Gerald Dhall, a portfolio manager with whom he had had occasion to speak before. Prior to relating any of the Secrist allegations, Dirks first ascertained that Institutional Capital did then own EFCA stock, though the size of the holding was not disclosed. Dirks told Dhall that a former Bankers National employee had told Dirks that EFCA's 1972 earnings were overstated, that EFLIC had been creating fictitious insurance policies and assets, and that EFLIC had been counterfeiting death certificates and certificates of deposit.

At Dhall's request, Dirks repeated the allegations to William Maloney, president of Institutional Capital. Maloney asked what basis Dirks had for relaying these rumors. Dirks replied that he had spoken to two former employees and also indicated he had an appointment to meet with EFCA's president Goldblum in Los Angeles on March 27. Maloney indicated that was not soon enough, that Dirks could get into a lot of trouble by relaying non-public rumors in this fashion, and that Dirks should fly to the West Coast immediately and confront Goldblum with the allegations. Indeed, Maloney offered to

defray Dirks's expenses in going to the West Coast.[30/]

After spending much if not most of the day on the 19th on matters relating to the Secrist allegations of fraud at EFCA, Dirks decided abruptly to accelerate his trip to Los Angeles. He took an 11:00 p.m. flight out of New York City and checked into the Beverly Wilshire Hotel in Los Angeles at 2:00 or 3:00 a.m. local time on March 20th. His unscheduled departure meant that Dirks's appointments for the 20th in Hartford, Conn., with three major insurance companies,had to be covered by his associates.

In Los Angeles, on March 20, Dirks met with Hopper from about 9:30 a.m. to approximately 4:30 p.m. Hopper related he had been at EFCA in Los Angeles until August, 1971, at which time he had been sent to Bankers National as vice president for investments. He said he resigned from Bankers National on December 14, 1971, but stayed on until March 10, 1972. He stated he resigned because EFCA officers had wanted him to engage in improper activities, including the use of Bankers National funds as compensating balances for bank loans to EFCA.

The conversation included a discussion of the fact that it was Hopper who suggested that Secrist approach Dirks when Secrist sought advice from Hopper as to how the EFCA fraud could be exposed.

30/ As it turned out, Maloney never thereafter offered to pay or share Dirks's expenses, and Dirks never asked for any assistance.

Hopper told Dirks that before leaving EFCA to go to Bankers National, he had heard allegations of fictitious insurance and other fraudulent practices and that later, at Bankers National, he talked with other middle-level executives who had been sent by EFCA to Bankers National, from whom he heard the same allegations emanating from different sources, including Secrist. Hopper told Dirks that these stories tended to confirm one another, even though, as he was frank to say, he had no first-hand knowledge of the alleged fraudulent practices.

Hopper told Dirks that one reason he tended to credit the allegations was a series of conversations he had had with Frank Majerus, whom he regarded as a "nice guy", a very hard worker, very honest, and as a man who was afraid he would be going to jail because of his involvement.

Hopper also told Dirks that he considered Secrist to be honest and sincere, though at times given to hyperbole or to making statements he could not back up. Hopper reported that Secrist had been fired by Bankers National.

Hopper supplied Dirks with substantial detail regarding the alleged fraud at EFCA. At times this differed in particulars from what Dirks had heard from Secrist but its overall effect as an objective matter was clearly to corroborate rather than to refute the Secrist allegations. Nothing that Hopper reported to Dirks contradicted the Secrist allegations in any significant particular.

In the course of the day's discussion, Dirks returned a call from Zukowski of III and put Hopper on the line to talk to III directly, as found above.

Beginning at about 1:30 p.m. on that same day, March 20, Dirks and Hopper met with Frank Majerus, a former comptroller of EFLIC who had also worked briefly at Bankers National and whose reports of fraud at EFCA Hopper had told Dirks he credited.

Most of the approximately 1-1/2 hours of conversation that followed was between Dirks and Majerus. After some initial hesitancy, Majerus freely discussed "Y business" and "special class" business, meaning policies issued to EFCA employees free of first-year premium.

Among other things, Majerus reported that as of the end of 1970 insurance in force at EFLIC was falsely made to rise sharply and that, at Lloyd Edens's request, he and Hopper had prepared false ledgers for earlier portions of the year in order to reflect a purported normal growth pattern for insurance in force. Dirks testified (R. 801) as follows about Majerus's reaction after reporting that information:

> And at that point he sort of dropped his head down and said, "I think I'm going to jail."

Majerus reported he had consulted his minister about the ethical problem he faced and was advised that in view of his family responsibilities he would be justified in remaining with the company until he could find suitable other employment.

Majerus reported that Jim Smith and Lloyd Edens had talked him out of resigning at one point but that, nevertheless, after a relatively short stay at Bankers National, he resigned to go with another insurance company.

The details that Majerus provided Dirks, though varying in some particulars, tended to confirm in important respects what Secrist and Hopper had earlier told Dirks. In addition, the greater personal involvement that Majerus conceded and his reports of his personal ethical problems and his fear of going to prison for his involvement, viewed objectively, afforded a significant additional element tending to support the truth of the allegations of fraud at EFCA.

Dirks urged Majerus to contact William Blundell, the Los Angeles Bureau Chief of the Wall Street Journal, to tell him what he had conveyed to Dirks. (Blundell had called Dirks on the 20th and made an appointment to meet with Dirks on the 21st after Dirks had on the 20th again called Lawson of the WSJ in San Francisco, advising him that he, Dirks, was now in Los Angeles and again seeking Lawson's help with the investigation of EFCA).

On the afternoon of March 20, Dirks, returning a call, spoke with Tomlin and Zimmerman of TZP, and conveyed to them only the so-called "soft story" about EFCA, as found above.

During the evening of March 20 Dirks called Baker of III to inform him of the results of his meeting with Majerus, as found above.

Before retiring for the night on March 20, Dirks, for the first time in his life, pulled up two or three chairs against his hotel room door, because of concern resulting from Secrist's allegations that EFCA employees had in the past been frightened into silence by threats that a Mafia "contract" would be put out on them.

On Wednesday, March 21, a.m. in Los Angeles and p.m. in New York City, Dirks learned in a telephone conversation with Zukowski that III had sold its EFCA holdings in client accounts and that Dirks's firm, Delafield Childs, would be receiving $25,000 in commission business from III, as found above.

On the morning of March 21, following a call from Goldblum suggesting that they get together, Dirks met with Goldblum and Levin at his hotel. Dirks chose to meet at a public place, the hotel's Hideaway Bar, rather than his hotel room, because he was concerned about his personal safety.

Upon meeting, Dirks asked Goldblum how he was. Goldblum replied " . . . not so good. Our stock just dropped four points on a block of 400 and some thousand shares . . . " Dirks responded " . . . my god, that must be the Boston Company . . . . " [meaning III].

Dirks told Goldblum and Levin that he had been talking to some former employees who were alleging the existence of

fictitious insurance policies at EFCA and briefly described the nature of the allegations. Both categorically denied the allegations, attributed them to disgruntled employees, endeavored to show how legitimate activities might have been misconstrued, and emphasized that it was preposterous to suppose that such a fraud would remain undetected by the cognizant regulatory bodies.

Following the meeting at his hotel, which lasted about a half hour, Dirks accepted Goldblum's invitation to visit the EFCA offices. Dirks spent about three hours there, in Levin's office, where he spoke, among others, with Goldblum, Levin, Edens and Smith. The EFCA personnel discounted and denied each of the several allegations of fraud that were there discussed. Nothing was said in this session that would conclusively prove or rebut the Secrist fraud allegations.

At about 3:30 p.m. on March 21 Dirks kept his appointment with Blundell of the _Wall Street Journal_. The meeting lasted 2 to 2-1/2 hours.

With the aid of his extensive notes, Dirks related to Blundell the substance of all he knew concerning the Secrist allegations of fraud at EFCA. Dirks showed Blundell his notes and described his meetings with Secrist, Hopper, Majerus, and the EFCA officers. Dirks ran through the names of the people Secrist had told him were involved or had knowledge of the fraud.

Dirks gave Blundell the phone numbers of Majerus, Hopper, and Secrist and asked Blundell to help investigate and publicize the allegations.

Shortly after his conversation with Blundell on March 21, Dirks received a call from Walter Delafield, to whom Dirks reported at Delafield Childs. Delafield reported that he had received a call from Jarvis Slade of New York Securities, an EFCA underwriter, complaining that a Bankers Trust analyst was making or relaying allegations of fraud at EFCA and that Slade had indicated he had determined Dirks to be the source of the allegations.

At about 8:00 a.m. on March 22, Dirks received a call from Goldblum. Dirks testified he got the impression Goldblum was trying to feel Dirks out as to what he was going to do. Goldblum said he was on his way to New York City and requested Dirks's permission to tell the New York Stock Exchange that Dirks was not alleging fraud at EFCA. Dirks gave his permission, saying he had merely related to (unspecified) others the same allegations of former employees that he had reported to EFCA officials the previous day.

Dirks then called Blundell and told him of his conversation with Goldblum. He also asked Blundell whether he was investigating EFCA and the latter responded that he was beginning to make checks.

At about 12:30 p.m., Los Angeles time, on March 22, Dirks spoke with Tomlin and Zimmerman of TZP, as found above.

Later that afternoon Dirks spoke with Orphanos of Dreyfus, as found above.

On March 22 Dirks placed a call to Peter J. "Ron" Ronchetti, a former EFLIC employee, but did not reach him. Later Ronchetti returned the call and they arranged to meet for breakfast the following day, March 23.

On March 22 Dirks also telephoned another former EFCA employee, Gene Thibodeau, whose name Secrist had suggested. Thibodeau was then working in Denver. Their conversation lasted about 20 minutes.

After Dirks inquired about the fictitious insurance allegations, Thibodeau confirmed that he had been employed in EFCA's computer department and said there was substance to the information concerning "Y business". Thibodeau told Dirks he had begun work at EFCA in October 1970 and that he had left a year later because he didn't want to be a part of the fraudulent activity. Thibodeau mentioned "department 99" as the computer code designation for certain fictitious insurance and suggested Ron Ronchetti and Don Goff as persons who might be able and willing to furnish additional data. Thibodeau said he was very glad that Dirks was looking into the matter.

As previously arranged, Dirks and Ronchetti met over breakfast on Friday, March 23, for about an hour.

Ronchetti told Dirks he had been at EFCA in Los Angeles until December, 1971, at which time he was transferred to

Bankers National. He said he remained there until July, 1972, at which time he was fired because he was critical of management.[31/]

Ronchetti said he was aware while he was there that EFCA had fictitious insurance on the books in 1970 and 1971 and provided details as to types, what it was called, and reports from a friend as to the numbers of fictitious policies extant as of year end in 1970, 1971, and 1972. He said he had heard of fictitious assets and fake death certificates and that there were death threats.

Ronchetti stated that while employed in EFLIC's computer department he had become convinced that certain blocks of insurance were fictitious, partly because there was a lack of back up materials for certain series of policy numbers.

In response to a question from Dirks as to who might be in a position to supply additional information, Ronchetti mentioned numerous individuals who were either participating in the alleged fraud or who had knowledge of it. Among those mentioned by Ronchetti as persons who might be helpful to Dirks were Brian Tickler, who had left EFCA only four months earlier, and Don Goff, a current employee, whom Ronchetti described to Dirks as knowing as much as or more than anyone. During the course of their discussion Ronchetti telephoned Goff and made

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31/ The record is not clear whether Ronchetti had returned to EFCA at Los Angeles sometime before being fired. See R. 1007, lines 19-21.

a luncheon appointment for the three of them for that day.

After the March 23 breakfast meeting with Ronchetti, Dirks telephoned Brian Tickler in San Francisco. They conversed for about 25 minutes. Tickler confirmed that he had worked for Datair Corporation, a computer service organization that had had a contract to do computer work for EFCA/EFLIC until March, 1972. Tickler said he personally had not worked at EFCA since the end of 1971.

After Dirks outlined the Secrist allegations, Tickler responded that he would stake his career on the existence of "Y" business at EFCA and EFLIC in 1970, though he couldn't be sure of 1971. He explained to Dirks the basis for his conclusion that in 1970 there were 10 to 12 thousand fictitious policies extant on the basis of what kept coming out on computer runs even after certain corrections had been made.

Tickler said departments "99" and "96" were special code numbers on the computer tapes designed to cover the phony policies.

Tickler told Dirks that Don Goff was aware of the fraud and that Ron Secrist was very worried and morally concerned about the whole matter.

Tickler also told Dirks that he was ". . . delighted that you're looking into this." (R. 1106).

During the morning of March 23, Los Angeles time, Dirks

had telephone conversations concerning the allegations of fraud at EFCA with Quinn of Dreyfus and Zukowski of III, as found above. On the same day Dirks placed a call to TZP intending to report details of what he had heard concerning allegations of insurance fraud at EFLIC, but he was unable to reach either Tomlin or Zimmerman.

Around mid-day on March 23 Ronchetti picked Dirks up, and they met with Goff over lunch for about an hour and a half to two hours. Goff, who was still employed by EFCA, had been a computer systems analyst and supervisor until moving into a "different area" towards the latter part of 1972. Among other things, Goff confirmed the existence of code designations for blocks of fictitious insurance. Goff indicated his understanding that there were 11,000 bogus policies in 1970, 45,000 in 1971, and 55,000 such policies in 1972. These figures were similar to but not identical to those Dirks had heard earlier from Ronchetti. Goff reported that he had heard that an EFCA employee aware of the bogus insurance had "embezzled" $35,000 by turning in 12 such policies to the re-insurers for cash value. Goff stated that he understood EFCA maintained a "mass marketing" or records-creation group away from its Century City offices, whose function it was to create fictitious back-up files and records for the bogus insurance. He said that EFCA utilized a printing plant somewhere to fabricate documents for that purpose.

Dirks concluded that Goff was " . . . very cool, calm and collected . . . ", ". . . a fairly credible type of individual", and that ". . . what he was saying was what some of the other people were saying . . . . " R. 1032.

After the luncheon meeting with Goff and Ronchetti, Dirks called Blundell of the WSJ. He told Blundell that he had spoken to one present and two former employees of EFCA who tended to substantiate portions of the Secrist allegations. Dirks gave Blundell the names and telephone numbers of Goff, Ronchetti, and Tickler, and related the substance of his conversations with them. Dirks asked whether Blundell would run a story in the Journal. Blundell responded noncommittally, but stated that he had reported the Secrist allegations to the Securities and Exchange Commission.

In the afternoon of March 23 Dirks conversed by telephone with Orphanos of Dreyfus, as found above.

On March 23 Dirks returned a call to Fiduciary Trust Company and spoke with Peter Alsop, with whom he had not had occasion to speak before. After Alsop indicated that Fiduciary held substantial EFCA securities, Dirks told him that he had spoken to several former EFCA employees and related to him the substance of their allegations of fraud at EFCA/EFLIC.

Additionally, during the week of March 19, Dirks spoke on several occasions with Dhall or Maloney of Institutional Capital to report the progress of his investigation. In one such conversation Dirks reported his meetings with EFCA

personnel and in another he reported that he had spoken to several former employees and one current employee of EFCA and that they tended to confirm portions of the Secrist allegations.

By late afternoon of March 23, after having spoken to one current and six former EFCA employees,[31a/] Dirks became concerned about exposing the fraud, if it was a fraud, as soon as possible. He was aware that Seidman & Seidman were planning to release a certified audit statement on Monday, March 26. Dirks believed that if he apprised them of the allegations they would hold up release of their audit report and would seek a trading halt from the New York Stock Exchange pending confirmation or refutation of the allegations.

Dirks called an acquaintance at the Centennial Corporation for guidance as to what top partner at Seidman & Seidman Dirks could talk to in confidence. Dirks then contacted the partner suggested and was told he could "feel very safe" in calling Robert Spencer, Seidman & Seidman's senior Los Angeles partner. Dirks contacted Spencer, who said it sounded like "quite a story." They agreed to meet the next day, a Saturday.

It occurred to Dirks that EFLIC's former auditors should also be apprised. At about 5:00 p.m. on March 23 Dirks called Michael Balint, the partner in charge of Haskins & Sells' Los Angeles office, to whom Dirks had spoken previously about EFCA. After Dirks outlined briefly the fraud information he had received, Balint advised him to leave his hotel immediately

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31a/ Tickler was not an employee of EFCA or a subsidiary, but as an employee of a contractor doing computer work for EFCA he had opportunity to acquire knowledge of the alleged fraud.

for his personal safety and call him back at home in about an hour. Dirks picked up his papers in a hurry and checked into the Beverly Rodeo Hotel under the name of Allen Gorrelick [his associate]. Dirks kept his room at the Beverly Wilshire Hotel, to serve as a place where he could continue to receive messages and, in Dirks's words, ". . . if anybody were coming after me, why, they wouldn't know I had left." (R. 1133.) When Dirks later called Balint at home, they made arrangements to meet for dinner the next night.

On Saturday, March 24, Dirks met with Spencer of Seidman & Seidman. Dirks related the general substance of the allegations of fraud at EFCA and then allowed Spencer to copy extensive notes he had taken. Spencer assured Dirks they would investigate the situation before releasing their impending certified audit report.

On March 24 Dirks called Orphanos of Dreyfus at home, as found above.

When Dirks met Balint of Haskins & Sells for dinner that evening, the latter rejected Dirks's idea that they dine near his hotel, saying that they had better get out of that area. They therefore drove some 20 miles down the coast to have dinner. They discussed EFCA for about seven hours. Dirks discussed the allegations he had heard in detail.

Balint said Haskins & Sells had been EFLIC's accountants since 1967 and that the firm's last audit of EFLIC was in 1971. Balint stated he knew nothing of the alleged fraud but expressed the view that if top management of the company were in collusion, had perpetrated a fraud, it was conceivable that that could have happened without the auditors' having become aware of it.

After his discussion with Spencer and Balint, Dirks believed it unlikely that EFCA stock would open for trading on Monday, March 26, because he expected trading to be halted by the NYSE.

On Sunday evening, March 24, Dirks met with Quinn of Dreyfus in Los Angeles, as found above.

On Monday, March 26, at about 10:30 a.m., Dirks learned in a telephone conversation with Ronchetti that Goff had learned that Seidman & Seidman had given copies of Dirks's extensive notes to top EFCA management.

As Dirks reported to Blundell of the WSJ, this little bit of intelligence caused him to run out of his hotel room in a "state of panic". Dirks asked whether Blundell could do something about publishing the allegations.

Later in the day, at about 3:00 p.m., Dirks again spoke to Blundell and asked if he was prepared to publish the story. Blundell indicated he was meeting shortly with three representatives of the SEC's Los Angeles Regional Office and got Dirks's permission for Blundell to ask whether the SEC wanted to

meet with Dirks, Hopper, and Majerus.

Later in the day Blundell called Dirks to report that the SEC officials would like to meet with Dirks, Hopper, and Majerus.

Several hours after that, Dirks and Hopper met with Blundell for several hours to discuss further the allegations of fraud at EFCA.

That evening, Dirks and Hopper contacted Gerald Boltz, the Commission's Regional Administrator in Los Angeles, and made arrangements to appear at the SEC's offices at 9:00 a.m. the following morning.

Apart from the foregoing, Dirks had a number of other contacts on March 26 concerning the allegations of fraud at EFCA. The order in which they are referred to here is not necessarily in chronological sequence.

On March 26 Dirks spoke with Bristol of Bristol & Co., Tomlin and Zimmerman of TZP, and Manning of Manning & Napier, all as found above.

On March 26 Dirks also related to personnel at the Savings and Profit Sharing Trust of Sears Employees the allegations of fraud at EFCA, including information regarding bogus policies, "Y" business, etc.

On the same date he called Fidelity Management and Research in Boston, but he did not relate the fraud allegations to them, because he learned they did not own EFCA stock.

On March 26 Dirks also returned a call to Lawton General, an investment subsidiary of Loews Corporation. Dirks spoke to Wallace Bowman, whom he understood to be in charge of Loews'investment portfolio. Dirks was aware at the time that Lawton had that morning purchased a substantial block of EFCA. Bowman said he'd heard that Dirks had a story about EFCA. Dirks replied that he assumed the stock Loews had purchased that morning was stock Bristol & Co. had sold, and that he'd give Bowman the same information he'd given Bristol. Dirks then gave Bowman the full story about allegations of fraud at EFCA as he understood them, and also put Hopper, who was with him at the time, on the line to talk to Bowman.

On the evening of March 26 Dirks received a call from Harold Richards of Fidelity Corporation of Virginia. Richards said Fidelity was the largest EFCA stockholder and said he'd heard Dirks was doing some analysis of EFCA. Dirks told Richards he'd been talking to some former employees and one current EFCA employee and that they had made allegations of fraud. Richards interjected and said he had a tape recorder running, to which Dirks responded that he had no objection. Dirks also urged Richards to come out to Los Angeles personally, but Richards demurred, saying he did not fly. Dirks gave Richards a pretty complete recitation of the allegations, as he had given Loews.

On March 26 or early March 27, Dirks related the allegations of fraud at EFCA to Steinhardt, Fine and Berkowitz. Early on March 27 Dirks conveyed briefly to an analyst at Morgan Guaranty the allegations of fraud at EFCA after learning that Morgan Guaranty had an interest in EFCA.

On March 27, sometime before 8:30 a.m., Los Angeles time, Dirks placed a call to an insurance analyst at the Ford Foundation. Unable to reach him, Dirks spoke instead to the head of research. Dirks did not recall the length of the conversation or the extent to which he went into the allegations of fraud at EFCA.

On March 27, at 12:45 p.m.,(E.S.T.), trading in EFCA securities was halted by the NYSE The following day, March 28, the SEC suspended trading in EFCA, securities.

In the course of Dirks's investigation into the allegations of fraud at FFCA and his selective dissemination of the allegations he heard to the selling respondents and to others, Dirks directly and indirectly used and caused to be used the mails and means and instruments and instrumentalities of transportation in interstate commerce, i.e. travel between New York and California and local and long distance telephone lines. In addition, in the course of such investigation and dissemination, Dirks, as is brought out more directly in other portions of this decision, directly or indirectly caused others to use, or aided and abetted their use of, the facilities of the New York Stock Exchange in liquidating EFCA holdings of their clients.

C. Elements of the charged violations; Respondents' contentions.

Trading by a corporate or other insider or his tippee on the basis of material inside information not publicly known and not properly disclosed is well established as a violation of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. 32/

Section 17(a) and Rule 10b-5 provide, respectively, as follows:

FRAUDULENT INTERSTATE TRANSACTIONS

> Section 17. (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly --
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.
>
> Rule 10b-5. Employment of Manipulative and Deceptive Devices.
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

32/ E.g. Cady, Roberts & Co., 40 S.E.C. 907 (1961); S.E.C. v. Texas Gulf Sulphur Co., 401 F. 2d 833 (2d Cir. 1968)(Rule 10b-5); Investors Management & Co. Inc., et al., 44 S.E.C. 633 (1971).

> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

The three numbered clauses of Section 17 and Rule 10b-5 have been held to be mutually supportive rather than mutually exclusive. Thus, a breach of the duty of disclosure may be viewed as a device or scheme, an implied misrepresentation, and an act or practice, violative of all three clauses. However, a finding of violation of a particular clause, e.g. clause (3), renders it unnecessary to consider whether the other two clauses have also been violated. 33/

Non-public information

The record herein establishes beyond serious challenge that the information regarding allegations of fraud at EFCA received by the individual selling respondents was non-public at the times they received it and at all times up to the times they sold or attempted to sell their clients' EFCA securities.

No published report of allegations of fraud at EFCA available generally to the investing public appeared until publication on April 2, 1973 of Blundell's Pulitzer-nominated article in the *Wall Street Journal*. The Dow Jones Broad Tape, *after* the close of trading on March 26, reported that heavy trading in EFCA had been accompanied by rumors concerning EFLIC, which rumors were reported as centering "... on the accuracy of the subsidiary's reported statements of new

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33/ *Cady, Roberts & Co.*, 40 S.E.C. 907, 913 (1961).

policies written and total insurance in force." The report contained no attribution of source or indication of magnitude or details of the problem. The gist of this report was published the next day in the Wall Street Journal, again without the details that would be necessary to make the information equivalent or comparable to that received by the selling respondents.

Even incident to or following the halting of trading in EFCA stock by the New York Stock Exchange on March 27 and the suspension of trading on March 28 by the Commission there was no publicly available report concerning fraud at EFCA analogous to the information received earlier by the selling respondents until the mentioned Wall Street Journal article of April 2.

Information derived from inside sources

Secrist and five other ex-employees of EFCA[32a/] and one current employee (Goff) of EFCA, from whom Dirks obtained information respecting allegations of fraud at EFCA in the course of his investigation, were clearly "inside sources" since they were reporting information that had come to their attention while they were employees of EFCA or an affiliate. Jacobs, The Impact of Rule 10b-5 (1974) § 66.02[a], at p. 3-275, note 46. These employees did not have to be officers (although most were in fact second-level managers or officers), directors, or controlling shareholders. Ross v. Licht, 263 F. Supp. 395, 409 (S.D.N.Y. 1967); S.E.C. v. Texas Gulf Sulphur,

32a/ See footnote 31a above.

258 F. Supp. 262, 279 (S.D.N.Y. 1966), affirmed in part, 401 F. 2d 833 (2d Cir. 1968).

The law is well settled that selling respondents as " tippees," even though they received their inside information wholly or in large part through an intermediary (Dirks), became subject to the same disclosure requirements as governed the insider "tippers", i.e. EFCA employees and ex-employees having information concerning the alleged fraud at EFCA. One who knows himself to be a beneficiary of non-public, selectively disclosed inside information must fully disclose or refrain from trading. S.E.C. v. Texas Gulf Sulphur Co., 401 F. 2d 833, 848 (2d Cir.1968)(en banc), cert. den. 394 U.S. 976 (1969); Shapiro v. Merrill Lynch, 353 F. Supp. 264, 276, 279 (S.D.N.Y. 1972); Fabergé, Securities Exchange Act Release No. 10174 (May 25, 1973)[1973 Decisions] Fed. Sec. L. Rep. (CCH) ¶79, 378, p. 83, 105; Investors Management Co., Inc. et al, 44 S.E.C. 633, 639-41 (1971); Merrill Lynch, Pierce, Fenner & Smith, 43 S.E.C. 933, 936 (1968).

Materiality of the inside information

Materiality is a mixed question of fact and law, involving as it does the application of a legal standard to a particular set of facts.[34/] The circumstances under which each selling respondent received non-public, inside information,

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34/ TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 450 (1976).

as found herein, were different, and the question of materiality must be determined individually for each selling respondent on the basis of the facts applicable to it.

The criteria or tests for determining materiality elucidated by the courts tend to take on colorations stemming from the particular facts involved, which makes discernment of a single, all-encompassing test of materiality difficult at best. One writer perceives three categories of tests:

> The courts have not settled on a single objective test to determine whether a fact is material. Three categories of tests can be discerned: One dealing with the judgment of a reasonable investor or reasonable stockholder, another weighing the probability that an event will occur against its indicated magnitude, and a third concentrating on the market impact of a disclosure. 35/

The first basic test referred to by Jacobs, as relevant to the instant proceeding, may be stated as follows: Would a reasonable investor consider the information important in deciding whether to purchase, sell, or hold. 36/ This test is stated in terms of "would" rather than "might" in view of the Supreme Court's decision in TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976), involving a proxy

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35/ Jacobs, The Impact of Rule 10b-5 (1974), § 61.02[b], pp. 3-74, 3-75.

36/ SEC v. Shapiro, 494 F. 2d 1301, 1305 (2d Cir. 1974); Radiation Dynamics v. Goldmuntz, 464 F. 2d 876, 887-88 (2d Cir. 1972); SEC V. Texas Gulf Sulphur, 401 F. 2d 833, 849 (2d Cir. 1968), cert. denied sub nom. Coates & Kline v. SEC 394 U.S. 976 (1969); List v. Fashion Park, 340 F. 2d 457, 462 (2d Cir. 1965); cert. denied sub nom. List v. Lerner, 382 U.S. 811 (1965); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 353 F. Supp. 264, 272 (S.D.N.Y. 1972); Investors Management Co. Inc., et al., 44 S.E.C. 633, 642 (1971).

solicitation under Rule 14a-9 issued under the Securities Exchange Act, where the Court, at p. 449, held, after discussing the "would" vs. "might" split among the circuits:

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. [emphasis supplied]

Prior lower court and Commission decisions respecting tests of materiality, including those cited above, must be read as having had their "thresholds" raised from the "might" to the "would" level wherever necessary. See, e.g., SEC v. Bausch & Lomb Inc., 565 F.2d 8, 14-15 (2d Cir. 1977).

Another basic test of materiality from the third category referred to by Jacobs, as relevant here, may be stated as follows: Would disclosure of the inside information, in reasonable and objective contemplation, have a substantial impact on the market price of the securities involved.[37/]

These two standards for determining materiality, i.e. the effect of inside information on a reasonable investor's

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37/ SEC v. Texas Gulf Sulphur, supra, 401 F.2d at 849-50; List v. Fashion Park, supra, 340 F.2d at 462; Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963); Investors Management Co., Inc., et al., 44 S.E.C. 633, 642 (1971); Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 937 (1968). Jacobs, The Impact of Rule 10b-5, §61.02[b] pp. 3-81, 3-82 (1974).

judgment and the impact of disclosure of the information on the market price of the involved security (Jacobs' categories one and three) are very similar and in all but a few situations overlap and coincide. Thus, information that would influence reasonable investors would cause a sufficient number of them to buy or sell (depending upon whether the information were favorable or unfavorable) to substantially affect the market price of the security. Likewise, inside information that would in the judgment of a reasonable investor substantially affect the market price of a security by causing a sufficient number of other investors to buy and sell would prompt him to buy or sell in anticipation of the expected market impact. While the U.S. Supreme Court has not in terms adopted the market-impact test, it is clear that the first test, which it does employ, is broad enough to encompass the market-impact test as well.[38/]

A third basic test of materiality, listed by Jacobs as his second category and described by him in shorthand terminology as the "probability yardstick,"[39/] comes into play only when the inside information involves an element of contingency or uncertainty as to the occurrence or existence of

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38/ Jacobs, supra, §61.02[b], pp. 3-83, 3-84.

39/ Jacobs, supra, §61.02[b], pp. 3-75, 3-81.

the event or condition that is the subject of the inside information, e.g. test bores that may or may not foretell a large mineral discovery, negotiations that may or may not result in a merger, acquisition, or large contract, and the like. Where these elements of contingency or uncertainty exist, the test holds that probability must be weighed against the magnitude of the impact the information would have on the inherent value or prospects of the company or on the market price of its securities. The greater the potential impact, the smaller is the degree of likelihood or probability that needs to be present to make the information material.[40/] This is but a reflection of how the objective, reasonable investor would be expected to respond to such circumstances, and is a corrolary of the other two basic tests.[41/]

Since the allegations of fraud at EFCA were not admitted or otherwise clearly established prior to the times of the

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40/ SEC v. Texas Gulf Sulphur, 401 F.2d 833, 849 (2d Cir. 1968) (preliminary drilling results found material); Investors Management Co., Inc., et al., 44 S.E.C. 633, 642 (1971) (adverse earnings projections, among other items); SEC v. Shapiro, 494 F.2d 1301, 1305-07 (2d Cir. 1974) (possible, though not probable, merger that would increase earnings 600%); Jacobs, supra, §61.02[b] p. 3-81.

41/ Jacobs, supra, §61.02[b] p.3-81.

alleged violations by the selling respondents, 42/ it is clear that the probability vs. significance basic test, along with the reasonable-investor and market-impact 43/ tests, needs to be employed in determining the issue of materiality. Under the facts presented by this record the three tests overlap considerably and will perforce at times be considered together.

42/ The record establishes that the basic allegations of massive insurance fraud at EFCA were in fact true and that such operations were but part of an even larger fraud that precipitated EFCA into bankrutpcy under a petition filed April 5, 1973, under Chapter X of the Bankruptcy Act. On or about April 10, 1973, the Court appointed a Trustee for EFCA, which was ultimately reorganized and is now doing business as Orion Capital Corporation. In his report of October 31, 1974 (Div. Exh. 1), the Trustee reported that the insurance phase of the fraud was another means by which EFCA inflated its reported earnings. This involved generating fictitious premium and re-insurance income on EFLIC's books. Bogus insurance known to the conspirators as "Y business" and segregated on EFCA's computers as "Department 99" was responsible for $5.5 million in non-existent premium income in 1970, and the figures for 1971 and 1972 were estimated at "up to $10 million" and "at least $14.67 million," respectively. The record establishes that Goldblum, Levin, and numerous other EFCA-EFLIC employees were involved in the fraud, as well as three accountants of the Wolfson, Weiner firm.

43/ The market-impact test discussed above is not to be confused with the so-called market information theory of liability. Market information has been defined as "information which emanates from non-corporate sources. . . primarily . . . concerning or affecting the trading markets for a corporation's security." Oppenheimer & Co., [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶80,551 at 86,415 n. 2 (Exchange Act Rel. No. 12319, April 2, 1976). In the instant proceeding knowledge of various selling respondents that Dirks as tippee was in turn selectively disseminating (tipping) the material inside information to others was inextricably interwoven with communication of the inside information itself to the selling respondents. Such knowledge was part of the totality of circumstances under which the selling respondents received the inside information. It therefore had a bearing on application of all three of the basic tests of materiality and should not be viewed as market information as if such had been received in isolation.

Lastly, courts have at times employed a subjective test of materiality by looking to what individual recipients did in response to the receipt of inside information.[44/] The better analysis is to view these uses of subjective indicia merely as applications of the reasonable investor test. That is, a court, or the Commission, having concluded that the recipient of inside information was under the circumstances in the position of a "reasonable investor," looks to his response to and use of the information as an indication of whether a reasonable investor under an objective standard would regard the information as material. This analysis retains the objective character of the basic tests of materiality. It should be noted in this connection that there is generally, or at least frequently, another reason for inquiring into a recipient's or holder's response to the receipt or possession of inside information, i.e. to establish whether he acted on the basis thereof or on the basis of some independent and unrelated cause.

In this proceeding most selling respondents contend they acted on the basis of independent motivations and considerations, and findings on those assertions are of course required. Depending upon their nature, such findings may also be relevant on the issue of materiality, and they are therefore treated

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44/ SEC v. Shapiro, 494 F.2d 1301, 1307 (2d Cir. 1974); SEC v. Texas Gulf Sulphur, supra, 401 F.2d at 851; Cady, Roberts & Co., 40 S.E.C. 907, 911-12 (1961); Jacobs, supra, §61.02[c], pp. 3-86 et seq.

under this issue.

In Investors Management [45] the Commission looked among other indicia of materiality, to the degree of specificity of the inside information, the extent to which it differed from information previously disseminated about the company, and its general reliability in light of its nature and source and the totality of the circumstances in which the information was received. These indicators are pertinent here.

Although each selling respondent received the inside information concerning allegations of fraud at EFCA in varying detail and in varying degrees of specificity, it is clear from the findings herein that each of them received information that clearly met the requirements of specificity. As a minimum, the allegation received was that there was bogus or phantom insurance in a substantial amount at a subsidiary of EFCA either presently or during a fairly recent period with a good possibility that some fraudulent insurance was still on the books. Most selling respondents heard a good bit more in terms of specificity, including code names for the bogus insurance, alleged involvement of management personnel, use of the computer in the alleged scheme, amounts of phony insurance in terms of percentage of policies or number of policies, fabricated and

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45/ Supra, 44 S.E.C. at p. 642.

falsified records to carry out the alleged scheme, creation of phony certificates of deposit and other assets, etc. Respondents do not much question the specificity of the allegations; they strongly contest the believability of the allegations, an element considered at a later point herein.

The allegations of fraud at EFCA were unlike anything that EFCA had either publicly or within the investment community ever been charged with before. Although some elements of the generally-conservative insurance industry and some elements of the investment community considered EFCA to have a "soft shoe" image and a reputation for favoring "liberal" accounting practices, none of that began to approach the specific allegations of widespread insurance fraud that are involved here. In no sense could these fraud allegations be put into a "so-what-else-is-new" category. While there had been vague rumors in the past concerning EFCA's accounting practices or similar matters, they bore no semblance to the specific, startling allegations here involved.

Respondents strongly contend the fraud allegations were inherently incredible and that they were unbelievable because they came from an unreliable source, a disgruntled, fired employee.

Respondents' arguments respecting the reliability and believability of the fraud allegations overlook a number of

significant factors.

Firstly, fired or disgruntled employees, although they may inveigh against their former employers, are not likely to risk their professional reputations by bringing serious fraud charges against them of a nature that, when disproved, would be bound to bring industry-wide discredit upon the accuser. Secrist came to Dirks for help in exposing what he considered a fraud at EFCA, not to damage EFCA in some surreptitious way that would forever protect his own identity as the informer. Dirks later learned that Secrist had also taken his allegations to an Eastern regulatory agency [the New York State Insurance authorities] and Dirks advised some of the selling respondents of that fact. Although Secrist at first asked Dirks to keep his identity secret, it became clear as events unfolded that Secrist was willing to speak to a number of people, including a representative of at least one selling respondent, in order to help expose the fraud, even at the risk of disclosing his identity. As Dirks's investigation progressed, Secrist was increasingly willing to let his identity become known.

Moreover, Secrist was not the only source of the fraud allegations. By the time Dirks conveyed the inside information to the last of the selling respondents he had talked to one current EFCA employee and six former employees.[45a/] By the

45a/ See footnote 31a above.

time Dirks completed his contacts with III, the first of the selling respondents to liquidate its clients' EFCA holdings, Dirks had talked to two other ex-EFCA employees: (a) Hopper (indeed, Hopper personally talked by phone with III) and (b) Majerus. As Secrist's allegations found support from additional ex-employees of EFCA and one current employee, the reliability of Secrist and each of the others as a source became enhanced and strengthened. Surely a reasonable investor would not suppose that they were all demented or misconstruing innocent facts and circumstances as a basis for serious fraud charges at the risk of their professional reputations.

This is not to say that these sources "established" or "proved" the fraud charges; but certainly they raised the likelihood that the charges had some validity to a level that would cause a reasonable investor to want to consider and weigh such information as a part of the "total mix" of information available to him about EFCA before making an investment decision.[46/]

Moreover, the fact that Dirks, an experienced insurance company analyst, was investigating the Secrist allegations and reporting his results to, among others, the selling respondents, is a fact that in itself, in the circumstances found herein, served to enhance substantially the believability

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46/ TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

and reliability of the particular fraud information received by each of the selling respondents.

While Dirks testified at the hearing in this proceeding that he did not believe the fraud allegations, his dogged determination and persistence in pursuing his private investigation into the allegations and his systematic program of selectively disclosing the results of his investigation to large institutions that held EFCA securities or "had an interest" unmistakeably belie his testimony.

Dirks's personal belief as to the likelihood that the fraud allegations were true is relevant at this point of the discussion because his belief must necessarily have reflected itself in the tone and in the conviction, or lack of it, with which Dirks communicated the fraud information to each of the selling respondents.

Dirks's early and growing belief that the fraud allegations regarding EFCA were to a significant extent more probably true than not true is evident from a large number of facts and circumstances.

Secrist approached Dirks with the allegations in the hope and expectation that Dirks would help expose the fraud by jogging the market for EFCA securities through dissemination of the information. As the findings herein show, Dirks promptly embarked on a course of selective dissemination of the

allegations that had precisely that effect. Even after Dirks became aware that his "tips" had prompted specific sales of EFCA securities in substantial amounts that were quite clearly adversely affecting the price of EFCA securities, he knowingly continued his program of selective dissemination to anyone who owned EFCA stock or "had an interest"in EFCA. My assessment of Dirks, formed during the extended periods of his testimony in this proceeding and on the basis of the entire record,is that he is not not a person who would in mean or reckless fashion have embarked upon and continued a course of conduct so clearly harmful to EFCA on a mere possibility that the charges were true and in order to "smoke out the truth" at such damage to EFCA. My assessment is that he would only have done so under a belief that the allegations, or a substantial portion thereof, were more probably true than not. This is particularly the case in light of Dirks's having previously met and known Goldblum and other officers of EFCA.

In connection with Dirks's rather extended campaign of selective dissemination of the fraud allegations, the findings show that Dirks made this his major, and for over a week virtually his sole,concern. In a couple of cases he put Hopper on the line to talk directly to his tippees. In a number of cases he gave tippees the names and phone numbers

of his informants, so that tippees would be free to make their own contacts if they desired. These actions by Dirks, under all the circumstances, indicate not a "neutral" posture on his part but that he was endeavoring to persuade the tippees that there was substance to the fraud allegations.

The findings herein also show that concurrently with his selective disclosures of the fraud allegations, Dirks repeatedly prompted a Wall Street Journal reporter to come out with a story on the allegations. Again, it is my judgment of Dirks that he is not a person so base or reckless as to have urged this course absent a belief that the allegations were more probably true than not. This conclusion is based not only upon an evaluation of his character in terms of willingness to harm EFCA but upon an a judgment that he was concerned enough about his own self interest not to have wanted to jeopardize his credibility and reputation both with the Wall Street Journal and with the investment community in which he worked by spreading serious fraud allegations absent a belief on his part that the allegations were more probably true than not.

What Dirks heard as his investigation progressed tended to confirm rather than to disprove Secrist's allegations, even though there were some peripheral contradictions or anomalies. At no time did Dirks tell any tippee that he disbelieved the allegations, even though he might have characterized the

allegations as "incredible." In the total contexts in which Dirks used the term, it is clear that he was employing "incredible" in the sense of "extraordinary" or "bizarre." As found herein, Dirks specifically told one tippee, John Bristol, that if he were in Bristol's position he would sell the EFCA holdings. Dirks's contemporaneous reports of fears for his personal safety also say much about the state of his belief.

Dirks's personal belief as to the reliability or believability of the fraud allegations can also be judged in terms of the effect he expected their dissemination to have upon his tippees. Testifying before representatives of the New York Stock Exchange, Dirks testified (R. 1920) in part:

> But I thought most of them would sell, if you want my opinion.

In light of all of the foregoing circumstances Dirks's testimony at the hearing that he at no time "believed" the fraud allegations is not credited; he obviously could not be sure, but his entire, extended course of conduct establishes that he believed a substantial part of the fraud charges to be more probably true than untrue.

The nature of the inside information is in itself a potent indication of materiality. A reasonable investor would recognize at once that allegations of widespread fraud at EFCA involving top management would, if true, have a devastating effect on EFCA both because of its effect on the assets or real worth of the company and because of the market impact on the

price of its securities. A reasonable investor would also realize that such allegations, in light of what they were and of the total circumstances in which the allegations were received by each selling respondent, would have a sharp negative impact on the price of EFCA securities, whether the allegations ultimately proved to be true or false. This last conclusion is so because a reasonable investor standing in the position of any one of the selling respondents would realize that in light of Dirks's continuing selective dissemination of the allegations, enough recipients of the information would sell the stock (without awaiting the ultimate proof or refutation of the allegations) to seriously depress the market price of EFCA securities.

This consideration of the nature of the inside information as an indication of materiality of course involves application of the probability vs. significance weighing test discussed earlier. The test is particularly applicable to this case. In view of the horrific nature of the fraud allegations, a reasonable investor would not be expected in all cases to wait for proof positive before disposing of his EFCA holdings. And, as III's trader Moore aptly expressed it, a rumor involving fraud would "spread like wildfire" within the brokerage community. III's Zukowski, likewise, recognized that the spreading of such information could be "deadly," as found above.

This does not mean that all reasonable investors would necessarily react uniformly to the receipt of the information received by each of the selling respondents. But it does mean that a reasonable investor would recognize that a significant enough number of recipients of the information would react by liquidating their EFCA holdings that the price of the stock would be seriously affected. Under the "probability yardstick" the fraud allegations were clearly material information.

As a further point under the general question of materiality there remains for consideration how the selling respondents regarded the fraud allegations and how they responded to their receipt of the information, 47/ i.e. the subjective application of the objective materiality tests discussed above. This exposition will show, concurrently, that the inside information received by each selling respondent was a significant element in its decision to sell its clients' EFCA securities. (See pp. 113-14 above).

The findings made herein show clearly that the inside information concerning allegations of fraud at EFCA received by Respondent III was deemed material and that it constituted

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47/ As suggested above, Dirks clearly viewed the information as material or he would not have been disseminating it to selling respondents and others. Also, as found above, he expected most of the firms he contacted to respond by selling their EFCA holdings, meaning that he expected most of them to regard it as material also.

a significant, indeed controlling, factor in III's decisions to liquidate its clients' EFCA securities. It is sufficient to highlight some of the more salient findings, without attempting to summarize all of the relevant findings.

Promptly after hearing the fraud allegations from Dirks, III initiated and continued extensive efforts to attempt to confirm or refute the information. III thus clearly recognized the significance of the information if true. The efforts at verification, or "checking," eventually involved all portfolio managers at III as well as Wise, who had no primary portfolio responsibility. Courtney had a lengthy face-to-face visit with Dirks and Gorrelick in which the fraud allegations were discussed in considerable detail. In addition, III made a legally-ineffectual stab at seeking legal counsel on the question of whether it was in possession of inside information (the defense of reliance upon legal counsel is treated separately below). Moreover, III, through Zukowski and Baker, continued to have numerous telephone discussions of the matter with Dirks over an extended period, both before and after Dirks carried his investigation to Los Angeles. The last of these contacts was a call from Dirks to Baker at the latter's home after Dirks had talked to Majerus, the third ex-employee contacted by Dirks, on the evening preceding III's completing its liquidation of EFCA holdings. Much earlier than the other portfolio managers,

Courtney had concluded that the fraud allegations required disposition of the EFCA holdings. Thus, Courtney's clients were sold out first and from that time forward he continued to urge the others to sell. Unlike the others, Courtney did not consider that there was any point in further "checking." In a limited sense Courtney was right, because after extensive checks with a former auditor and with co-insurance companies and others, III was still not in position positively to confirm or refute the fraud allegations. However, as a result of the delay, III did become aware that three former employees told a basically consistent story and that the source therefore was not Secrist alone. These added confirmations, along with the inability to refute the allegations and the circumstances of III's realization that Dirks-induced sales of EFCA securities (including the Courtney-client sales) were already having a negative effect on the market price of EFCA securities and that that trend would continue as Dirks kept up his program of selective dissemination, combined to prompt the ultimate III liquidations. Significantly, III decided to liquidate its clients' very substantial EFCA holdings in the face of a prior determination that they would hold the securities pending an expected rally that had not materialized. III personnel testified that they realized that the fraud allegations and their selective dissemination by Dirks had killed off all possibilities of a rally. Finally, two _res gestae_ type actions

of III are significant: First, as a direct consequence of the fraud information given by Dirks, III directed brokerage business worth over $23,000 in commissions to Dirks's employer, Delafield Childs;[48/] second, in reporting to his "bosses" the reasons for the EFCA liquidations, Courtney, employing somewhat euphemistic language, said that III had ". . . received disquieting information from the broker concerning potential adverse developments affecting the company," as found above.

Respondent Bristol & Co., as evident from the facts found above, also considered the allegations of fraud at EFCA that it received material and acted on that information to liquidate its clients' EFCA holdings. (The question of whether certain transactions were "sales" within the meaning of the relevant statutes is treated separately at a later point.) Bristol & Co. first received information concerning alleged fraud at EFCA from personnel at III after III had just completed liquidating its clients' EFCA holdings and at a time when Bristol was in the process of acquiring EFCA shares for a client of Bristol & Co. After having purchased 66,000 shares of EFCA for the client on March 22 (which purchase, ironically, came out of shares its affiliate, III, had sold),

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48/ Testimony that this commission business was unrelated to the inside information furnished is not credited, based upon credibility evaluations and the record as a whole.

Bristol & Co. suspended its intended purchase of additional EFCA shares for the client and commenced to check out the allegations with various insurance analysts and two executive vice presidents of EFCA. The EFCA executives denied there was any substance to the rumors and the insurance analysts contacted either discounted the rumors or could not be helpful. Nevertheless Bristol had about concluded that the existence of the fraud allegations and the fact that Dirks was selectively disseminating the allegations dictated a liquidation of Bristol & Co. clients' EFCA holdings even before he and an associate held a telephone conversation with Dirks. Dirks stated that in Bristol's position he would sell and also advised that he (Dirks) had prevailed upon Majerus to talk to the former EFLIC auditors, Haskins & Sells, and that he (Dirks) had been talking to a Wall Street Journal reporter. From this last, Bristol inferred that the Journal would shortly be coming out with an unfavorable story regarding EFCA. Dirks also expressed the view that he doubted that trading in EFCA would be allowed to continue in view of his contacts with the former auditors. After this conversation with Dirks, Bristol & Co. moved to liquidate its clients' holdings in EFCA as rapidly as possible. Clearly, the rapid decision to abort further purchases of EFCA stock and instead to liquidate all clients' holdings in EFCA by Bristol & Co. was caused by its receipt of inside information regarding allegations of fraud at EFCA and knowledge of the

circumstances surrounding the selective dissemination of such allegations.

Respondent The Dreyfus Corporation, as the findings herein show, also considered the inside information it received concerning allegations of fraud at EFCA to be material and sold the EFCA debentures of its client, DSIF, on the basis of such information. Before learning of the fraud allegations from Dirks, Dreyfus had placed a sell order for the EFCA debentures with Goldman, Sachs because Quinn considered the holdings inappropriate for DSIF. After learning from Goldman, Sachs that Dirks had a "story" about EFCA and that the market for the stock was unsettled, so that it could be sold only at a deep discount, Dreyfus suspended the sell order pending further checking with Dirks and others. After hearing the fraud allegations from Dirks by phone, Quinn formed the impression Dirks believed them to be true and he called Orphanos at home to have him follow up with Dirks to get further details. Quinn meanwhile decided to meet with Dirks in Los Angeles, since the former was going there on business in any event. Orphanos had a number of phone conversations with Dirks, in one of which he obtained the names and phone numbers of at least 4 former EFCA employees who purportedly knew about the fraud. Over the weekend of March 24-25 Orphanos spoke with ex-EFCA employees Secrist, Thibodeau, and Tickler. 48a/ Based on all he had heard, Orphanos came to credit the truth of the fraud

48a/ See footnote 31a above.

allegations and conveyed that view to Quinn. Orphanos reached this view notwithstanding contrary views received from Mercy at Goldman, Sachs and denials from EFCA's Levin and Arkus-Duntov. Quinn met with Dirks on the evening of March 25. The next day, having been unable to disprove the substantial evidence that the allegations of fraud at EFCA were true, and since Orphanos, in particular, tended to credit the truth of the allegations, Dreyfus sold the debentures. The decision to sell, which involved incurring a loss on an investment that had but recently been made, was motivated by the possession of inside information regarding the allegations of fraud at EFCA and the circumstances concerning the selective dissemination of those allegations.

Respondent Manning & Napier contends that its decision to sell the EFCA stock was made prior to Manning's talking with Dirks and for reasons that were independent of his receipt of inside information regarding the allegations of fraud. The record does not bear out this contention. Although Manning was indeed closely monitoring EFCA along with a half dozen or so other stocks for some time and had considered selling the stock for a week to 10 days prior to the actual sale, the record shows that the sale and the decision to sell were not in fact made until, as found herein, Manning came into possession of the inside information regarding the allegations of fraud at EFCA, including awareness of the market impact selective

dissemination of the allegations was having. He responded to such inside information by selling.

The materiality of the specific allegations of fraud at EFCA as contrasted with the materiality of more vague "soft story" allegations is underscored by the disparate responses to the two allegations of Respondent Tomlin, Zimmerman & Parmelee, Inc., as disclosed by the findings above. TZP, after hearing a "soft story" from Dirks was persuaded on March 23 to purchase an additional 3,000 shares of EFCA, even though it considered that Dirks would continue selectively to disseminate that story. This decision was made in the belief that the soft rumors had had their maximum effect and that a substantial purchase would "wash out" the stock. Later, on March 26, after having heard from Dirks the "hard story," i.e. the report of allegations of insurance fraud at EFCA, and after having come to the belief that Dirks would continue to selectively disseminate <u>those</u> allegations, TZP promptly liquidated all of its clients' EFCA holdings.

In support of the selling respondents' contention that the inside information concerning allegations of fraud at EFCA received by them was not "material", they rely heavily upon an argument that runs, in effect, as follows: (1) a number of entities, including the SEC the NYSE, the insurance departments or commissions of various states, the <u>Wall Street Journal</u>, and a number of individuals and private entities became aware of the allegations of fraud at EFCA; (2) they

did not treat the allegations as "fact" or react to the allegations in a way that would have indicated they regarded them as material; and (3) therefore the allegations of fraud at EFCA that the selling respondents received were in fact and in law not material.

A number of considerations operate to deprive this argument of all but minimal weight.

First of all, as has been seen, the recognized test of materiality is the objective, reasonable-man test. Therefore an argument involving inductive reasoning predicated upon how given individuals or entities viewed particular factual situations is of very limited utility. (Compare pp. 113-4,123-130 above, where the responses of selling respondents to the receipt of inside information are examined for a dual purpose.)

Secondly, Respondents' argument confronts the difficult task of establishing that the particular factual situation of individuals or entities upon whose reactions they would rely were in fact sufficiently analogous to those encountered by a selling respondent to be valid as an indicator. In a number of instances the record contains no such proof. Again, Respondents would have to show that the individuals or entities whose reactions are relied upon were in the posture of a "reasonable investor," a burden that in some of the reactions upon which they rely they are unable to sustain.

A third flaw in Respondents' argument is the aspect

thereof that argues that the individuals and entities upon whose reactions they would rely did not view the allegations of fraud at EFCA "as a fact." This contends that to find materiality here the allegations of fraud would have to have been established as a fact. However, as concluded hereinabove in discussing the probability yardstick test as well as the market-impact and reasonable-investor tests of materiality, there is no rigid requirement that inside information be established as an incontrovertible fact, or anything close to that, before it can be found to be material. The inherent nature of the information and all relevant circumstances under which it is received must be taken into account.

As respects the actions of the New York Stock Exchange the record shows that on March 22 Jarvis Slade and Saul Cohen of New York Securities reported to the Exchange that at a luncheon meeting of analysts an allegation of fraud at EFCA had been overheard. Dirks was not identified as the person reporting the allegations nor were details of the alleged fraud known or reported. The Exchange contacted EFCA management, which denied the allegation. On Friday, March 23, Goldblum personally met with Exchange personnel in New York City and strongly denied any and all rumors about EFCA, without focussing on the fraud allegations or identifying Dirks as the person reporting the allegations. At first, Exchange personnel tended to accept these denials by management, though they continued to monitor the stock price closely. Later, however, after

learning inter alia that Dirks was reporting the fraud allegations, and after the Dow Jones Broad Tape carried a report on March 26th that heavy trading in EFCA was accompanied by rumors questioning the accuracy of EFLIC's insurance in force, coupled with appearance of an article of similar purport on March 27, in the Wall Street Journal, the New York Stock Exchange halted trading in EFCA. Significantly, the Exchange halted trading in EFCA in recognition of the market impact of the fraud allegations and without awaiting proof of the allegations "as a fact." In short, the Exchange properly recognized the materiality of the fraud allegations even before certain events on March 30 made it appear highly probable that there was substantial truth to them.

The SEC first learned on March 9 that Secrist had taken his allegations of fraud at EFCA to the New York State Insurance Department. This occurred when an official of the California Insurance Commission met on that date with the Branch Chief of Investment Company Inspection in the Los Angeles Regional Office of the SEC to advise him that the California Commission had been advised of the Secrist allegations by the New York State Insurance Department. The information alleging fraud that was received by the SEC Branch Chief was substantially less detailed and less specific than what Dirks had received from Secrist. Unlike the situation of the selling respondents, the Branch Chief

did not receive information that an experienced insurance analyst, Dirks, was reporting the Secrist fraud allegations or that the allegations had been received from more than one former EFCA employee. The Branch Chief tended to disbelieve the Secrist allegations and indicated that in any event SEC personnel were too busy on other matters to be able to assist California in investigating the matter for several months. The Branch Chief's memorandum concerning this meeting did not come to the attention of the Commission's Los Angeles Regional Administrator until Monday, March 26. However, after the Commission's Director of the Division of Enforcement in Washington, D.C. and officials in the Regional Office in Los Angeles were both informed on Friday, March 23, by Blundell of the Wall Street Journal that a number of former EFCA employees had alleged fraud at EFCA in talks with him, the Commission took prompt investigative steps that included, *inter alia*, interviews with Blundell on the 26th and interviews and depositions of Dirks, Hopper and Majerus on the 27th. On March 28, without any positive proof of the truth of the allegations of fraud at EFCA and without any certain knowledge as to what was causing the price of EFCA securities to fall, the Commission suspended trading in EFCA. The Commission did so recognizing that whether the allegations of fraud were being made because of a belief in their truth

or as part of a bear raid, and regardless of the truth or falsity of the allegations, the fact of their existence and their selective dissemination were clearly having a negative market impact on the price of EFCA securities. As was true of the NYSE's halt in trading, the Commission acted to suspend trading before the occurrence of certain events on March 30 that made the truth of the fraud allegations appear to be highly probable. 49/

William Blundell, Los Angeles Bureau Chief of the Wall Street Journal, first heard the report of allegations of fraud at EFCA from Dirks in a meeting between the two that lasted several hours on March 21. Dirks told him the substance of what he had heard by that time, and gave him names of former employees who might talk to him. Blundell followed up on the allegations personally rather than delegating the matter to a subordinate. After speaking with Secrist, Blundell began an investigation of his own that was to last about ten days and involve interviews of 14 to 20 persons. From March 21 through March 30 he devoted virtually all of his working

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49/ Late in 1971 an attorney in Los Angeles informed personnel of the Commission's Regional Office in Los Angeles that William Mercado, then an EFCA employe, alleged *inter alia* that EFCA carried substantial fictitious insurance on its books. After some investigation and failure to find any supporting or corroborating data, the inquiry was dropped. Assuming, *arguendo*, that staff personnel failed to follow up the lead adequately or perseveringly enough, this would not establish Respondents' argument that such allegations of fraud are inherently incredible and therefore immaterial.

hours plus some time of his own to investigation of this potential story. By Friday, March 23, he considered the information he then had of significance to the SEC. He thought the Commission might want to consider suspending trading in the stock. After getting Dirks' permission, he conveyed the information, as already found above, both to the Assistant Regional Administrator in Los Angeles (the R.A. was home ill) and to the Director of the Division of Enforcement in Washington. Between March 21 and March 26 Blundell formed the belief that at least key parts of the fraud allegations were true ". . . after talking to a couple of people at Equity Funding who admitted to me that they had engaged in various criminal actions and who emotionally broke down about this thing." (R. 8702).

On March 26, after EFCA's Goldblum had been reported as denying the rumors about EFCA without being willing to identify the nature or substance of the rumors, Blundell submitted for publication on the Dow Jones Broad Tape at 4:16 p.m. on that day and in the Wall Street Journal on the morning of the 27th a brief, generalized characterization of the rumors, already referred to hereinabove (p.105-6). These two reports stated that the heavy trading in EFCA was accompanied by rumors that centered on the accuracy of EFLIC's reported statements of new policies written and total insurance in force. These general and limited published characterizations of the nature of the

rumors concerning EFCA were initiated by Blundell because he felt that in light of Goldblum's denial of the rumors while refusing to state their nature, the "reader", or the "public," was entitled to know at least that much about the nature of the rumors. Blundell commenced writing his detailed "expose" article concerning the EFCA fraud that appeared in the Wall Street Journal on Monday, April 2, on the previous Friday, March 30, when he learned that the Illinois Insurance authorities had discovered that $22 million of EFCA assets in the form of bonds supposedly deposited with a Chicago bank were in fact not there and had not been there for a considerable period. Also on March 30th, the California authorities seized EFLIC and Goldblum and Levin chose to exercise their 5th Amendment rights in projected testimony before personnel of the SEC.

When considered in the light of the proper tests for determining materiality, as discussed above, rather than under unsupportable criterion urged by Respondents -- i.e. that the allegations of fraud at EFCA would have had to have been established as fact) beyond question (or at least have been universally accepted as fact) -- it is clear from the foregoing findings that the reactions of the NYSE, the SEC, and Blundell of the Wall Street Journal, once they came into possession of information reasonably equivalent to that received

by the several selling respondents, supports rather than negates a finding of materiality.

When Secrist reported his allegations of fraud to the New York State Insurance Department on March 7, the same day he met with Dirks[50/] and Gorrelick, he set in motion a chain of reactions that ultimately involved the insurance departments of New York, California, Illinois, and New Jersey in investigating or making inquiry as to those allegations, since each of those states had jurisdiction to one degree or another over EFCA or one of its affiliates. Respondents urge that by and large these state regulatory officials gave little or no credence to the Secrist allegations and that none of them, including Illinois and California, which undertook a joint examination of EFLIC, uncovered any proof that the allegations of Secrist were "fact" until some time after the transactions involving the selling respondents occurred. From these premises, Respondents contend, it follows that the Secrist allegations were not material. Neither of the two prongs of this argument is valid. To treat the second point first, as already discussed extensively above, it is not necessary that inside information be established as proven "fact" or universally

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50/ As previously found, Dirks did not learn that Secrist had gone to a state insurance department on the East Coast until March 19.

accepted "fact" for it to be material. As to the first point, the record shows clearly that the information concerning the Secrist fraud allegations available to the state regulatory personnel was a very long way from being comparable to the inside information that each of the selling respondents had available. In essence, the state regulatory personnel had nothing more than the allegations from Secrist (New York and Illinois personnel talked to him in face-to-face meetings while the others received his allegations indirectly in one degree of detail or another). For whatever reasons, the state regulatory personnel did not have the relevant statements of other ex-EFCA employees. Nor did they have the results of Dirks's marathon investigation of the fraud allegations or Dirks's evaluation of the results and import of his investigative activities. There is a significant difference between the allegations of one ex-employee and the totality of information the selling respondents had, including of course the overall circumstances in which they received it. Accordingly, it would be bootless to examine in detail the reactions of the state regulatory personnel since they were not operating on the same information that was available to each of the selling respondents.

Respondents also urge that the allegations of fraud at EFCA were not material because a number of other private persons and entities did not believe them to be, or treat them as,

"fact." What has been said heretofore about the principle that materiality does not under the circumstances involved in this proceeding require that the fraud allegations be established as "fact" or universally accepted as "fact" is equally applicable with respect to this argument of Respondents. Moreover, except for persons or entities that were tipped by Dirks directly [51/] and except for some officers or employees of EFCA referred to by Respondents, there is lack of satisfactory proof in the record that persons and entities referred to by Respondents had received inside information as extensive, detailed, or legally significant on the materiality issue as that received by selling respondents. As found elsewhere herein, Goldman, Sachs did not possess the same inside information that Respondent Dreyfus did, and there is no satisfactory proof in the record that Salomon Brothers possessed inside information of the nature, detail, or legal significance of that possessed by Bristol & Co. or other selling respondents. Additionally, as to certain entities referred to in Respondents' argument, a strong predisposition not to believe the allegations, quite apart from the nature of the inside information at hand, existed because of special ties to Goldblum or Levin of EFCA. Thus, J. Ira Harris

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51/ As to why some of these "tippees" did not sell EFCA, the record is insufficiently developed to permit findings.

of Salomon Brothers was a long-time acquaintance of Goldblum. Lawrence Tisch, of Loews Corporation, was introduced to Goldblum by Harris. Mercy, of Goldman, Sachs, was a long time personal friend of EFCA's Levin, with whom he talked frequently. Individuals such as these three, because of the special ties, had such strong faith in the integrity of Goldblum or Levin that their reactions to whatever inside information they had was not objective, and their reactions are therefore not significant on the issue of materiality. For somewhat analogous reasons, the fact that some high level officials of EFCA may have disbelieved or discounted the allegations of fraud, does not support Respondents' materiality argument.

Based upon the findings made herein, considered under the legal tests of materiality discussed herein, it is concluded that at the time of the relevant transactions each selling respondent was in possession of material inside information regarding EFCA and that in each case the inside information constituted either the only, or a significant, factor in each selling respondent's decision to liquidate its clients' EFCA holdings.

Bristol & Co.'s no-sale defense

Respondent Bristol & Co. concedes that its sale of the 600 shares of EFCA common stock from the Bristol & Co.

Employees' Profit Sharing Plan settled in due course with Clark,Dodge & Co. and that it constituted a completed sale. However, respecting the transaction involving 457,200 shares of EFCA common stock, as to which Salomon Brothers refused delivery of the shares and out of which litigation resulted,and respecting the transaction involving $200,000 in face amount of EFCA convertible debentures with Loeb, Rhoades, which did not settle and has remained open, Bristol & Co. defends on the ground that since there was no completed sale there can be no violation because there was no one to be "defrauded."

In examining this defense it should be noted that the conduct proscribed by Section 17(a) of the Securities Act is substantially identical to the conduct proscribed by Rule 10b-5 under the Exchange Act as pertinent here (see pp. 104-105 above) except that the reach of the respective provisions is in part different in that the former involves conduct "in the offer or sale of any securities" while the latter involves conduct "in connection with the purchase or sale" of any security."

The unsettled Bristol & Co., client transactions, whether or not they occurred in or in connection with a purchase or sale of securities, clearly involved an "offer" [52/] of securities,

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52/ By order dated October 12, 1977, the Division's motion to amend the Order for Proceedings in various particulars in order to conform the Order to the proof was granted. The principal effect of the amendment was to add an allegation that the violations alleged occurred "in the offer or sale" of EFCA securities to the previous allegation that the violations occurred in connection with the purchase and sale of EFCA securities.

defined in Section 2(3) of the Securities Act[53/] to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." The inside-information rule is based as much on Section 17(a) of the Securities Act as it is on Rule 10b-5 under the Exchange Act.[54/] Given the purpose and rationale for the inside-information rule -- i.e. to protect the integrity and fairness of the securities markets and the public's faith and confidence in them -- no reason is apparent why Section 17(a) does not proscribe offers in violation of the inside-information rule as much as it proscribes sales in violation of the rule. The purpose and rationale for the development of the inside-information rule by the Commission and the courts are fully consistent with the purposes Congress had in enacting Section 17(a), in which it chose to attach the same consequences to offers in violation of the Section's terms as to sales in violation of the Section. Doubtless this was in recognition of the fact that sales frequently result from offers and that even when they do not, offers in violation of the Section can nevertheless have a deleterious effect upon the integrity of the securities markets.

53/ 15 U.S.C. §77b.

54/ Cady, Roberts & Co., 40 S.E.C. 907 (1961); Investors Management Co., Inc., et al., 44 S.E.C. 633 (1971).

The instant situation well exemplifies this. Bristol & Co.'s effort to dispose of 457,200 shares of EFCA common at a discount of $1 1/2 from the market price of $19 and its effort to dispose of $200,000 face amount of EFCA debentures clearly had an impact on the price of EFCA regardless of the fact that the sales did not ultimately settle. This means that sellers in the market sold for less than they would have if Bristol & Co. had not initiated its huge transactions. And, although an individual might be unable to recover from Bristol & Co. because of any of a number of reasons that are significant in litigation between private parties, this does not mean that in a disciplinary enforcement action such as this the Commission is unable to vindicate the public interest. It is well settled that a private litigant's remedy will not always be co-extensive with the Commission's broader enforcement powers as the agency designated by Congress to carry out the primary enforcement role under the securities laws. 55/

In addition, the "unsettled" transactions in EFCA securities initiated by Bristol & Co. on behalf of its clients constituted sales as defined in §3(14) 56/ of the Exchange Act, which defines the term "sale" to include "any contract *to*

55/ *Fridrich* v. *Bradford*, 542 F.2d 307, 320-21 (6th Cir. 1976).

56/ 15 U.S.C. §78c(14).

sell." (Emphasis added). When the EFCA common stock of Bristol & Co.'s clients was traded over the NYSE or crossed, in-house, Bristol & Co. had, through its selling broker, Salomon Brothers, concluded executory contracts to sell with Salomon Brothers' customers, Salomon Brothers' house account, and the numerous other ultimate purchasers set forth on Division's Exhibit 42, Schedule C. The Act's definition of sale as including a "contract to sell" does not concern itself with whether the contract to sell is void or voidable for fraud or any other reason or with whether there is ultimately an exchange of stock for value.

Similarly, when Bristol & Co. solicited and accepted Loeb, Rhoades' bid for the 200 EFCA debentures, it entered into an executory contract to sell within the meaning of the Exchange Act.

Cases relied upon by Respondent Bristol & Co. that require a settled or completed sale in private litigation presenting questions of standing to sue or the ability of a plaintiff to prove damages are simply not relevant in this disciplinary enforcement proceeding, where the Commission is vested with authority to vindicate the public interest in a much broader sense. As found above in discussing the "unsettled" transactions as offers under the Securities Act of 1933, the record contains ample evidence that such offers adversely affected the market for EFCA securities and therefore damaged

participants in that market during the relevant period. The market and investors treated these trade-date transactions in EFCA the same as any other transactions in these securities, regardless of the fact that the trades did not ultimately settle.

As bearing in a general sense on the broad scope of the public interest that the Commission is required to vindicate, it is not without significance that Respondent Bristol & Co. seeks to avoid responsibility for any consequences flowing out of the unsettled transactions even though it was its own alleged misconduct that caused the intended sales to be aborted or not carried to fruition and even though it has itself never sought to rescind these contracts to sell.

The Division further contends that as respects some 20,000 shares of the 457,200 shares "traded" by Bristol & Co. on behalf of its clients the trades actually did settle. 57/ The record contains uncontradicted testimony that this occurred-- not through delivery or surrender of any stock certificates of Bristol & Co.'s clients, but through operation of the on-balance clearing and settlement procedure. 58/ Salomon Brothers on the date in question evidently had other transactions in EFCA stock and in the balancing out or netting out process

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57/ These included purchases by Lily Levy and Walter Rogers, who testified that they bought and paid for EFCA stock.

58/ See Stock Clearing Corporation Rule 8, NYSE Guide, CCH ¶3308.

some 20,000 shares of EFCA stock got delivered to purchasers identified on Exhibit 42 as purchasers of the stock Bristol & Co. had agreed to sell on behalf of its clients.[59/] These results were forseeable by Bristol & Co. and justify treatment of the transactions represented by the 20,000 shares as completed sales.

Lastly, as to this defense, the Division claims that Bristol & Co.'s participation in a settlement of litigation involving it and Salomon Brothers, among others, constitutes acknowledgement by Bristol & Co. that it did, at least *pro tanto*, engage in sales of EFCA stock on behalf of its clients. In view of the diverse reasons for which parties enter into settlements, and in view of the "clear and convincing" standard of proof being applied in this decision, no such inference is drawn here from the mentioned settlement.

Failure to disclose

The record establishes, as found herein, that each selling respondent failed to disclose material inside information prior to entering into the transactions that form the

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59/ The record does not show precisely the source of these 20,000 shares of EFCA stock or whether there was any effort to reverse or rescind these settled sales after Salomon Brothers refused to accept delivery of EFCA stock from Bristol & Co.

basis for its alleged violations. Only Respondent Dreyfus contends it did make proper disclosure. Respondents Dreyfus and Bristol & Co. contend they were not required to disclose because the other sides to their respective transactions already had substantially the same inside information these Respondents had.

As found herein (pp. 54-5 above) Quinn of Dreyfus conveyed to Mercy of Goldman, Sachs on Friday, March 23, the substance of certain allegations of fraud at EFCA that Quinn had heard on that date in a telephone conversation with Dirks. Mercy, as found above, expressed disbelief in the allegations, attributed to a "former employee" of EFCA, that EFLIC had put hundreds of millions of dollars of bogus insurance representing tens of thousands of fictitious policies on its books, had fraudulently re-insured the bogus insurance, and had issued phony death certificates as part of the scheme.

However, as found herein, Dreyfus did not disclose to Goldman, Sachs any information the former received in its continuing investigation into the matter subsequent to Quinn's conversation with Mercy of March 23. As found herein (see pp. 56-9 above), this information subsequently acquired by Dreyfus included significant elements of inside information going beyond that which Quinn had related to Mercy. Without repeating the previous findings in detail, certain significant items may be noted. Dreyfus learned subsequently in further

conversations with Dirks that Don Goff, a current employee of EFCA, "confirmed" the alleged fraud. Dreyfus also obtained from Dirks the names and telephone numbers of four former EFCA employees with whom Dirks had spoken, including Secrist, his original informant. Over the weekend of March 24-25 Orphanos of Dreyfus personally telephoned Secrist and two other former employees of EFCA, Thibodeau and Tickler.[59a] Either by what they told him, or by how they responded, these ex-employees tended to confirm the allegation of fraud at EFCA.

On the evening of Sunday, March 25, Quinn met with Dirks in Los Angeles. At this meeting Dirks told Quinn that Dirks had contacted additional employees since their last telephone conversation, who corroborated information he had gotten earlier, and that Dirks had begun to fear for his personal safety after having been cautioned by a representative of EFCA's former auditors. Dirks also told Quinn that he had arranged with Majerus and Hopper to meet with Blundell of the Wall Street Journal, to whom Dirks had relayed the allegations of fraud at EFCA, and that he had requested Majerus, former comptroller of EFLIC, to tell his story to a Mr. Balint, the partner-in-charge at Haskins & Sells, EFLIC's former auditors. Dirks advised that Majerus had called Balint.

These items of inside information acquired after the March 23 Quinn-Mercy phone call were all highly material, tending as they did to corroborate the earlier report of

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59a/ See footnote 31a above.

allegations, which attributed the allegations to a single ex-employee. They should have been disclosed to Goldman, Sachs.

Dreyfus argues broadly that Goldman, Sachs knew as much or more than Dreyfus knew about the allegations of fraud at EFCA. But there is no support for this contention in the record. There is nothing to support a finding that Goldman, Sachs was aware that 3 or more ex-employees and one current employee of EFCA all tended to confirm the fraud allegations, or that they were in possession of the other material inside information that Dreyfus acquired after the March 23 phone call. While there is evidence that Mercy made numerous phone calls to his friend Levin at EFCA regarding the rumors or allegations, there is nothing in the record to show that Goldman, Sachs as a result of such conversations or otherwise learned the material inside information that Dreyfus acquired after the March 23 phone call. Since Goldblum and Levin were "stonewalling" in response to all inquiries about the rumors, it seems highly unlikely that either would have furnished any kind of detail regarding the allegations that could be construed as tending to corroborate them.

The Division also contends that even if Dreyfus had made adequate disclosure to Goldman, Sachs that would not have been enough. The Division contends that, even though Goldman, Sachs purchased the EFCA debentures from Dreyfus's client on a principal basis, the transaction cannot be regarded

for disclosure purposes as comparable to face-to-face private transactions. This, the Division urges, flows from the fact that Goldman, Sachs during the relevant period was in effect functioning as a market maker in EFCA debentures and that Dreyfus was well aware that Goldman, Sachs was so functioning. Therefore, the argument concludes, public disclosure rather than disclosure merely to the purchaser was required.

While the Division's position on this point is considered to have great merit, particularly in light of the nature of the inside information here involved, it is unnecessary to rule expressly on the point in view of the conclusion reached herein that material inside information acquired by Dreyfus subsequent to the March 23 Quinn-Mercy phone call was not disclosed to the purchaser (Goldman, Sachs).

With respect to Bristol & Co.'s defense as regards its lack of disclosure, it must be noted at the outset that it is not claimed to be applicable to the 600 shares of common stock sold to Clark, Dodge & Co. or to the $200,000 face value convertible debentures contracted to be sold to Loeb, Rhoades. The defense applies only to offers or agreements to sell made to or through Salomon Brothers. The intended ultimate purchasers, including Salomon Brothers, some of its customers, and other broker-dealers or their customers, are shown on Schedule C of Division's Exhibit 42. The defense is that Salomon Brothers

(and a few of its major customers) were as aware of the fraud allegations as Bristol & Co. was, that information possessed by Salomon Brothers would be imputed in law to ultimate purchasers for whom it acted as agent, and that there was thus no legal necessity for making disclosure to Salomon Brothers. Bristol & Co. does not claim it was aware on March 26, the trade dates of the relevant transactions, that Salomon Brothers (or any of its clients) had the inside information.

The (partial) defense lacks merit for two major reasons.

First, the record does not substantiate the claim that Salomon Brothers (or its major customers) had material inside information of the same or substantially the same significance as Bristol & Co. had. While Salomon Brothers and some of its major customers were aware of the allegations of fictitious insurance at EFCA and that Dirks was the source of the allegations, and, indeed, had discussed the allegations with Goldblum and other personnel of EFCA, who denied they had any validity, there is no proof in the record that Salomon Brothers, et al. had the kind of corroborating details that increased likelihood that Bristol & Co. had. (Incidentally, Bristol & Co. did not call witnesses from Salomon Brothers to attempt to establish the nature or extent of their knowledge of the fraud allegations). For example, Bristol & Co., as found herein, was told by Dirks

that he had talked to a number ("various") former employees of EFCA and that the situation did not look good (the inference would be that the various employees interviewed corroborated one another). Also, Bristol received a "recommendation" from Dirks to dispose of the stock, based on his by then lengthy and extensive investigation into the Secrist allegations. Furthermore, Bristol & Co. learned from Dirks that he expected an unfavorable Wall Street Journal report to come out imminently and that he also expected a trading halt or suspension in EFCA securities shortly. So far as the record shows, Salomon Brothers *et al.* had none of these significant, corroborative elements of material inside information -- most of what they had by way of "inside" information were fervent but generalized denials from top EFCA management.

From a legal standpoint, too, Bristol & Co.'s partial defense respecting disclosure lacks merit. There is clearly no principle of law under which any knowledge Salomon Brothers may have had can be imputed to the numerous ultimate intended purchasers in the transactions in which Salomon Brothers acted as agent for Bristol & Co. and traded on the NYSE with contra brokers acting for ultimate purchasers, e.g. Levy and Rogers.

Since Bristol & Co. had no understanding or reason to believe that Salomon Brothers was purchasing the EFCA stock for its own account, disclosure to Salomon Brothers alone would not have

sufficed -- full public disclosure was required before transactions could be entered into.60/

Wilfulness, scienter, and related issues

Respondents contend that under the holding of the Supreme Court in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), a showing of scienter, i.e., "a mental state embracing intent to deceive, manipulate, or defraud" is required under both Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and Section 17(a) of the Securities Act.

As to Section 17(a), it is concluded that Respondents' argument is not well founded. S.E.C. v. World Radio Mission, Inc., 544 F.2d 535, 541 n. 10 (1st Cir. 1976); contra, Sanders v. John Nuveen & Co., Inc., 554 F.2d 790 (7th Cir. 1977); S.E.C. v. American Realty Trust, 429 F. Supp. 1148, 1171 (E.D., Va. 1977). The World Radio court stated, in the footnote cited, as follows:

60/ In Dupuy v. Dupuy, 551 F.2d 1005, 1015 (5th Cir. 1977) the Court, in the context of a private suit presenting the question whether the plaintiff had exercised due diligence to protect himself against alleged fraud, in discussing the distinct requirements applicable in private suits as contrasted with enforcement proceedings, stated in part as follows:

> ". . . The dispositive element in these [the enforcement] cases is that the defendant owes a duty of full and fair disclosure to the public, not to any particular investor. Whether a private plaintiff might be precluded from recovery, then, need not alter the distinct consideration whether a defendant has violated duties imposed by the Act. . . ."

A commentator makes the point as follows:

(Continued on next page)

10. Defendants engage in a technical argument, that since the language of section 17(a) of the 1933 act is virtually identical to that of Rule 10b-5 and since Hochfelder read section 10(b) of the 1934 act, under which Rule 10b-5 was promulgated, as requiring scienter, section 17(a) must be similarly interpreted. This is a non sequitur. The Hochfelder Court recognized that Rule 10b-5(2), making it unlawful "to make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading," is not, by itself, limited to intentional deceit; but the Court held that the rule, if so interpreted, would exceed the authority of section 10(b) of the statute. 425 U.S. at 212-214, 96 S.Ct. at 1390-1391. Section 17(a), however, is a congressional enactment, not an SEC rule, and it contains the same language which the Hochfelder Court recognized did not require scienter. Thus, strictly speaking, since this action is founded on both section 17(a) and Rule 10b-5, we need not decide what result would obtain in an SEC injunction action based solely on section 10(b) and Rule 10b-5 — though we do think it implausible to suppose that Congress intended to provide a mechanism for the SEC to protect the public from the injurious schemes of those of evil intent and yet leave the public prey to the same conduct perpetrated by the careless or reckless.

Although World Radio was a suit for injunction, its rationale on the point at issue is equally persuasive in enforcement proceedings such as this. Moreover, the rationale applies both to the second and third numbered clauses of Rule 10b-5 and Section 17(a), respectively. See Hochfelder, supra, 425 U.S. at 212. The reasoning of World Radio and the clear

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60/ (footnote continued)

Since in any active market disclosure to a particular individual is not feasible, the duty to disclose, if such a duty exists, must be owed to all members of that ill-defined class of stockholders who, with the benefit of inside information, would alter their intention to [buy].

Painter, Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5, 65 Colum. L. Rev. 1361, 1378 (1965).

implications of Hochfelder itself are persuasive and are not negated or attenuated by any of the contrary holdings. Further authority supporting this conclusion as to Section 17(a) is found in Steadman Securities Corp., et al. [current] Fed. Sec. L. Rep. (CCH) ¶91,243 (Investment Company Act Release No. 9830, June 29, 1977), appeal pending (5th Cir.); 12 SEC Docket 1041, July 12, 1977.

As to Rule 10b-5, Hochfelder, supra, was silent as to applicability of the scienter requirement to SEC administrative enforcement proceedings, though it expressly reserved judgment as to its applicability to SEC injunctive suits. The Commission in Steadman, supra, concluded that proof of specific intent to defraud was not required by Hochfelder in SEC disciplinary enforcement proceedings.

Since the Commission there found the "scienter" requirement to have been met, conclusion was technically dictum; nevertheless its treatment of the issue suggests the Commission intended it as a definitive statement of its position.

The only judicial decision offering any view on the issue in a disciplinary proceeding is Arthur Lipper Corp. v. S.E.C., 547 F.2d 171, 180-81, n. 6 (2d Cir. 1976) rehearing denied March 22, 1977, 551 F.2d 915, certiorari denied, 46 U.S.L.W. 3429 (Jan. 10, 1978). There the Court assumed, arguendo, without deciding, that the Hochfelder culpability

standard was applicable to SEC disciplinary enforcement proceedings but, since it concluded that on the facts that standard had been met, the Court found it unnecessary to decide the point. 61/

In the instant proceeding it is likewise not necessary to decide whether the Hochfelder scienter requirement applies under Rule 10b-5. This is so for two reasons. Firstly, the findings herein establish that the culpability standard of Hochfelder has been met, and, secondly, if a reviewing tribunal should conclude that intent to deceive within the meaning of Rule 10b-5 had not been established, violations as charged would nevertheless be established under Section 17(a), under which intent to deceive need not be established.

In determining what the proper standard of culpability was in an SEC administrative disciplinary proceeding under an assumption of Hochfelder's applicability, Judge Friendly in Lipper wrote in part as follows (547 F.2d at 181):

61/ Judge Friendly, writing for the Court, seemed to express a leaning in favor of a view that Hochfelder does apply to SEC administrative enforcement proceedings. However, the language quoted from the opinion in World Radio, supra, would seem to suggest a belief that Congress could not have intended the Hochfelder culpability requirement to apply to Section 10(b) enforcement actions since it provided otherwise (as the Court concluded) with respect to Section 17(a), whose provisions are substantively identical to those of Rule 10b-5. Conceivably the ruling in Hochfelder could come to be narrowly applied to its facts, i.e. cases involving private litigants relying on a judicially-inferred right to sue, since a substantial measure of the Court's reasoning in Hochfelder depends upon statutory provisions for private litigants in other sections of the Exchange Act.

Putting aside for the moment the defense of reliance on the advice of counsel, we do not regard the Hochfelder decision as carrying the day for petitioners. The Court held that in order to create liability for damages under Rule 10b-5—and we assume in petitioners' favor that the same standard governs proceedings under §15, see fn. 6 — there must be proof of intention "to deceive, manipulate, or defraud" — not an intention to do this in knowing violation of the law. The Court reasoned that the language of §10 suggested that the section "was intended to proscribe knowing or intentional misconduct," 425 U.S. at 197, 96 S.Ct. at 1383.[7] It thought that use of such words as "manipulative," "device," and "contrivance" made "unmistakable a congressional intent to proscribe a type of conduct quite different from negligence," 425 U.S. at 199, 96 S.Ct. at 1384. And it referred, 425 U.S. at 202, 96 S.Ct. at 1385 to the oft-cited testimony of a sponsor of the Act before the House Committee on Interstate and Foreign Commerce that what became §10(b) says "Thou shall not devise any other cunning devices." While that phrase could not be regarded as including negligence, it reads precisely on what petitioners did here — charging the full NYSE commission rates on IOS generated OTC transactions and rebating half of these to IPC, a subsidiary of IOS, knowing that IPC would retain the sums paid to it although these should have been turned over to the funds directly or applied to reduce the advisory fee. It is no answer that petitioners may not have realized that this "cunning device" was a fraud.

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7. Indeed, even in the criminal context neither knowledge of the law violated nor the intention to act in violation of the law is generally necessary for conviction. The first proposition seems implied by the rule ignorantia juris non excusat. Hall, Criminal Law 288 (2d ed. 1961). And the second, of course, follows from the first. Perkins, Criminal Law 745 (2d ed. 1969). See ALI, Model Penal Code §§ 1.13(12), 2.02(2)(a) &(b); Ellis v. United States, 206 U.S. 246, 257, 27 S.Ct. 600, 602, 51 L.Ed. 1047 (1907), where, in rejecting a claim that knowledge of the law was required for conviction under a statute that included the word "intentionally", Justice Holmes said, "If a man intentionally adopts certain conduct in certain circumstances known to him and that conduct is forbidden by the law under those circumstances, he intentionally breaks the law in the only sense in which the law ever considers intent."
[Remainder of footnote omitted.]

In the instant proceeding the record and the findings establish that each selling respondent acted entirely or in material part on the basis of material inside information concerning fraud at Equity Funding in selling, offering to sell, or agreeing to sell, EFCA securities to known or unknown purchasers without disclosing to such purchasers the inside information in its possession. In each case the decision to sell, offer, or agree to sell was knowing, deliberate, and intentional, not inadvertent or negligent. In each case the decision to withhold the inside information from purchasers or prospective purchasers rather than to disclose it was knowing, deliberate, and intentional, not inadvertent or negligent. The fact that each selling respondent acted in whole or in material part on the basis of the inside information, under circumstances found herein, indicates its awareness that the inside information was material. It was clear that the information was from inside sources. And Respondents were well aware of the long-settled law that selling on the basis of material inside information without proper disclosure is a fraudulent or deceptive act, practice, or course of business. Thus, their knowing, intentional commission of such an act or practice itself evidences an intent to deceive the purchasers. Intent to deceive is inherent in the nature of the offense, absent inadvertence or good faith considerations.

The Commission in _Steadman_, _supra,_ 12 S.E.C. Docket at

p. 1051, found an intent to deceive under the following analysis:

> What we have here is:
>
> (1) a duty to reveal; plus
> (2) an intent to conceal; and
> (3) actual concealment.

These elements are all present in the instant proceeding.

Likewise, the findings made herein more than meet the culpability standards applied by the Court in Lipper, supra, under its assumption of Hochfelder's applicability to administrative disciplinary proceedings brought by the Commission. In Lipper, Judge Friendly concluded that "[i]t is no answer that petitioners may not have realized that this 'cunning device' was a fraud." Supra, 547 F.2d at 181.

Respondents contend they could not have had the requisite intent to deceive because they did not believe the allegations of fraud at EFCA. However, as developed above, under the "probability yardstick" test for materiality, it is not necessary that an allegation having significance be established as fact or universally believed before it becomes material. As already noted, each selling respondent did in fact act on the basis of inside information and the fact of having acted on the basis of the information itself evidenced recognition of its materiality. Respondents' argument that they did not recognize the materiality of the inside information they

acquired is therefore not persuasive. Thus selling Respondents knew or should have known they would be committing a wrongful act, a deception of the purchasers, if they failed to disclose the inside information each had. Moreover, under Lipper, knowledge that they were acting in contravention of law would not be required to satisfy the scienter requirement.

The argument of some Respondents that they believed the inside information they had was already public knowledge is so lacking in support in the record as to come close to being frivolous.

Respondents contend they acted in good faith because state insurance laws and libel laws prohibited publication or dissemination of the allegations of fraud at EFCA and that they lacked other means of ensuring that the allegations became public, while their fidcuiary obligations compelled them to sell in the face of falling EFCA prices and circulating allegations of fraud.

The "dilemma" erected by Respondents in illusory, a chimera.

It is settled law that a trustee's obligations to his or its beneficiaries do not require the commission of an illegal act. See Scott, Trusts, §§ 61, 166 (3d. ed. 1967). The Commission has stated in Investors Management Co., Inc., et al., 44 S.E.C. 633, at p. 647 (1971), in pertinent part

as follows:

> . . . The obligations of a fiduciary do not include performing an illegal Act [sic; footnote citations omitted] . . . And there is no basis for the stated concern that a fiduciary who refrains from acting because he has received what he believes to be restricted information would be held derelict if it should later develop that the information could in fact have been acted upon legally. If that belief is reasonable, his non-action could not be held improper.

Cady v. Roberts, 40 S.E.C. 907, 916 (1961) is to the same effect.

Under the facts in the instant proceeding, Respondents would have been justified, indeed required, to refrain from trading in the absence of a proper disclosure. In view of this it is unnecessary to consider whether State insurance laws precluded disclosure (on their face, some of the statutes cited appear not to be germane) or the effect of libel laws. Likewise, it is unnecessary to consider whether other avenues for getting the requisite disclosure made were closed to Respondents. In passing, it may be observed that Respondents made no effort to contact the NYSE the SEC, or any other regulatory body that might have been in position to require or influence EFCA to make proper discosure of the allegations of fraud at EFCA.

Respondents III, Bristol & Co., and Dirks urge reliance upon advise of counsel as evidence of good faith.

The Commission holds that reliance upon advice of counsel may be used in mitigation on the issue of sanctions

but cannot make unlawful conduct legal. Arthur Lipper Corporation, Securities Exchange Act Release No. 11773, October 24, 1975, at p. 16, n. 41, affirmed in part, reversed as to sanctions, Arthur Lipper Corp. v. S.E.C., 547 F.2d 171, 181-2[62/] (2d Cir. 1976), cert. den., 98 S.Ct. 719 (1978).

Apart from the legal effect of reliance upon advice of counsel in appropriate circumstances, it is clear from the facts found herein that none of the three claimants establishes good faith reliance upon advice of counsel.

III, which sought legal advice after it first heard something of the fraud allegations from Dirks, materially misinformed Attorney Evans of the recency of the informant's employment with an EFCA affiliate. In a second phone call, on March 14, Courtney failed to tell Evans about the fact of and substance of Courtney's long face-to-face discussion with Dirks and Gorrelick on the following day. III never re-checked with Evans after III collected additional corroborative information from continued contacts with Dirks and as a result of other extensive checking III did. Moreover, III breached Evans'

62/ In rejecting petitioners' contention of reliance on counsel, the Court concluded the defense was not available because counsel was unable to give wholly disinterested advice and therefore found it unnecessary to consider the Commission's ruling on the point.

admonition not to contact EFCA directly or indirectly by talking to EFLIC's re-insurers and to Dirks, who talked to additional EFCA ex-employees, i.e. Hopper and Majerus. In short, III's attempt to obtain a legal opinion was perfunctory. Evans never received the full information required to enable him to render an informed opinion and his caveat was not fully observed. In these circumstances III's claim of good faith reliance upon the advice of counsel is not substantiated.

Bristol & Co.'s claim to reliance in good faith upon advice of counsel is even less well founded than that of III. Bristol & Co. relies upon the fact that on March 23 III's Baker told Bristol & Co.'s Smith that III had sought and obtained an oral legal opinion and guidelines from Evans. Bristol & Co. was unaware of what "facts" III had given or failed to give Evans as the basis for his legal opinion. In any event, the "facts" confronting III when it sought legal advice were not the "facts" confronting Bristol & Co. when it should have sought a legal opinion of its own. Dirks told Bristol on Monday, March 26, that he had talked to various EFCA employees over the weekend -- after III had liquidated on the 21st -- and that what he had heard "was not good" and that if Dirks were in Bristol's position he would sell the EFCA stock. In addition Bristol formed the impression from his conversation with Dirks that the Wall Street Journal would soon be coming

out with an unfavorable story on EFCA. In addition, Dirks told Bristol he doubted trading would continue in EFCA securities because Dirks had talked to the former auditors, Haskins & Sells, and had prevailed upon the former Comptroller of EFCA [Majerus] to talk to Haskins & Sells about the fraud allegations. All of these were significant elements of information that Bristol & Co. had that III could not have had when it sought Evans's legal opinion. Moreover, Bristol & Co. violated the "guidelines" Evans had given III by talking directly to Levin and Arkus-Duntov, two top level officers of EFCA, in an attempt to obtain confirmation or denial of the fraud allegations. In view of these deficiencies and other relevant circumstances, Bristol & Co. can hardly claim reliance in good faith upon advice of counsel.

Dirks's asserted good-faith reliance upon the advice of counsel is clearly contradicted by the record. He contends that on March 14 and again on March 21 he was told by personnel of III that III had informed its counsel [Evans] of the Secrist allegations in detail and had been advised that the fraud allegations were not covered by the inside information rule and that Secrist was not an insider. There is no indication in the record that III led Dirks to believe that it had sought or obtained any legal opinion subsequent to March 14. As the findings herein abundantly evidence, Dirks

kept receiving additional inside information from additional insiders subsequent to March 14 and through March 26 on a continuing basis, and he selectively disseminated such information during that period. Obviously an opinion rendered on the basis of information available as of March 14 would not necessarily be valid on the basis of "facts" Dirks kept accumulating thereafter, and he had no reason whatever, as a sophisticated and experienced analyst, for supposing that it would.

Dirks also relies on his having disclosed the Secrist fraud allegations to Richard Weiss, an insurance lawyer whom Dirks had on occasion engaged, without receiving from Weiss any reaction or advice that this was inside information. The disclosure occurred in a chance meeting on March 19, before Dirks took off for Los Angeles to pursue his investigation in greater earnest. Weiss was neither asked for, nor did he volunteer, an opinion as to whether the Secrist allegations of fraud were inside information. Dirks relies on Weiss's silence as indicating that everything was all right. The record does not indicate that Weiss was qualified or experienced in securities law so that he could have rendered a reliable opinion had one been requested. And, of course, as indicated with reference to the Evans legal advice, even if Weiss had rendered an opinion on the 19th, it would not have held good

without further consultation in light of the significant additional inside information Dirks acquired from other inside sources after March 19th and through March 26th. Dirks is far too experienced and sophisticated to have been under any good faith belief that he had any basis for relying upon "advice of counsel" upon either of the bases discussed above.

Respondent Dirks also urges that his gathering of information concerning the allegations of fraud at EFCA and his selective dissemination thereof are protected by the free speech provisions of the First Amendment to the Constitution. The argument lacks merit.

The findings herein make it clear that Dirks was involved in such activities not as an agent of the press or as a free-lance newsgatherer but in his capacity as an analyst of insurance company securities. Thus, if Dirks is to gain any comfort from the First Amendment it must come from the cases applying the First Amendment to commercial speech.

But the law is clear that the protection afforded to commercial speech is not absolute -- that it does not remove a business engaged in the communication of information from general laws regulating business practices. The principle was well stated in Savage v. C.F.T.C., 548 F.2d 192, 197 (7th Cir. 1977), where the Court stated in pertinent part:

Commercial speech is entitled to a measure of First Amendment protection, Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council, 425 U.S. 748, 96 S.Ct. 1817, 48 L.Ed. 2d 346 (1976), but it has long been recognized that the Amendment does not remove a business engaged in the communication of information from general laws regulating business practices. As Justice Harlan stated in Curtis Publishing Co. v. Butts, 388 U.S. 130, 150, 87 S.Ct. 1975, 1989, 18 L.Ed.2d 1094 (1967):

> "A business 'is not immune from regulation because it is an agency of the press. . . .' Federal securities regulation, mail fraud statutes, and common-law actions for deceit and misrepresentation are only some examples of our understanding that the right to communicate information of public interest is not 'unconditional.'" (Citations and footnotes omitted).

Dirks argues that there was a "significant public interest" in the allegations of fraud at EFCA. Of course there was. And Rule 10b-5 and Section 17(a) are designed among other things to ensure that the public at large will obtain access to such information since it is material to investment decisions. But the effect of Dirks's activities at least in the short term was to give such information not to the public at large but selectively to a small fragment of the investing public. Dirks's argument would turn violation of law into virtue.

Dirks also urges in connection with his First Amendment defense that judicial decisions applying it hold that its protection is unavailable only if he acted in violation of law with scienter. The cases relied upon are, in my view, misconstrued or misapprehended. However, since the findings herein conclude that Dirks did act with the requisite scienter to support findings of the charged violations, it is unnecessary

to discuss these particular First Amendment cases.

As found herein, Dirks disseminated the allegations of fraud at EFCA selectively in the expectation and belief that most of the recipients of the information would act on it and sell their EFCA holdings. He continued to disseminate such inside information after he had received strong indications that at least two recipients of the information had acted on it to sell substantial quantities of EFCA securities. On these and on all the findings affecting Dirks it is concluded that he acted in the expectation, and with the intent, that a percentage of the recipients of the inside information would act upon it and liquidate their EFCA holdings.

Dirks's motivations for the selective disseminations were twofold. Firstly, he hoped that his selective disclosures, by depressing the price of the EFCA securities, would be instrumental in leading to exposure of what he believed, as previously found herein, was probably a fraud at EFCA. Secondly, the selective dissemination was expected by Dirks to develop good will towards him and his brokerage firm among actual or potential clients for his services as an analyst . With respect to III, as found, it actually resulted in commission business for his firm.

That Dirks concurrently with his selective dissemination to others also disclosed the inside information to Wall Street Journal reporters and urged them in effect to print

the allegations does not negate his intent or scienter with respect to the selective disclosure to others. Dirks proceeded on two tracks, both heading towards the same result --ultimate exposure of what he believed was probably a fraud. Had Dirks confined his disclosures to the Wall Street Journal reporters (or had he gone to cognizant regulatory or self-regulatory bodies) instead of also disclosing selectively to investors, he might indeed have been perceived as the public-spirited hero he seeks to portray himself as in this proceeding. He chose, instead, to employ the two-track pattern he in fact employed out of a belief, as evidenced by the entire record and observation of Dirks and other witnesses, that these methods would give him higher visibility and greater public recognition as an analyst and an opportunity at the same time to develop direct good will and potential future clients as respects the firms to whom he selectively disseminated the inside information.

If the record did not establish, as found herein, that Dirks acted with the expectation and intent that a number of the tippees to whom he selectively disclosed inside information concerning the EFCA fraud allegations would act on such information, it would at the very least establish that he acted in reckless disregard of the foreseeable consequences of his campaign of selective disclosure.

Respondent Dirks also contends in effect that for him to be found to have wilfully aided and abetted violations by the selling respondents it must be established (1) that his conduct would not subject him to primary liability for violation of Rule 10b-5 or Section 17(a); (2) that a selling respondent committed a violation as charged; (3) that Dirks knew that his role was part of the overall fraudulent activity leading to a violation by a selling respondent; (4) that Dirks acted with the specific intent to defraud; and (5) that Dirks substantially assisted the violation.

Contention (1) above is made on the premise that since Texas Gulf Sulphur, supra, 401 F.2d 833, 852-3 establishes that a "tipper" such as Dirks may be primarily liable for a Rule 10b-5 violation he cannot logically be "secondarily" liable as an aider and abetter for the same acts or conduct. Evidently Dirks makes this point out of concern that some lesser level of culpability may apply to aiding and abetting than applies to "primary" violations. In Texas Gulf, a suit for injunction, the tipper was held to have violated Rule 10b-5. His tippees were not parties to the suit, though there was a finding that some acted on the basis of the "tips".

In the instant disciplinary enforcement proceeding, it would seem that Dirks's conduct more properly constitutes an aiding and abetting although, logically, contrary to Dirks's contention, there is no reason why the tipper's act,

if tipping is itself a violation under applicable case law, could not also be an aiding and abetting where the facts and law warrant such findings and conclusion.

In any event, it is clear from the findings herein that all of Dirks's suggested criteria for finding an aiding and abetting violation are met here. Dirks clearly substantially assisted the violations by selling respondents -- indeed he put into motion the whole chain of events that resulted in such violations. Dirks was also well aware that his role was central to the violations by others -- as found herein he was aware that others had sold on the basis of fraud allegations conveyed by him and he expressly advised Bristol that if he were in his situation he would sell the EFCA securities. Moveover, Dirks expected most of his tippees would sell and wanted them to do so in order to achieve his purpose of exposing what he believed to be a probable fraud at EFCA. Dirks knew that the clearly foreseeable consequence of his disclosures of material inside information was that purchasers would be defrauded and he was willing to have that occur as the price of exposing the probable fraud and advancing his own interests with actual or potential clients. Thus, he intentionally aided and abetted the defrauding of purchasers (and of the investing public generally).

Conclusions of law

In general summary of the foregoing, it is concluded that during March of 1973, the indicated respondents committed violations of the following provisions of law or rule as a result of the following acts, practices, and failures to disclose, all as more particularly found above:

(1) On particular dates in March, 1973, as more particularly found above, Respondents The Boston Company Institutional Investors, Inc., John W. Bristol & Co., Inc., The Dreyfus Corporation, Manning & Napier, and Tomlin, Zimmerman & Parmelee, Inc. wilfully violated Section 17(a) of the Securities Act of 1933, as amended, 15 U.S.C. §77q(a), Section 10(b) of the Securities Exchange Act of 1934, as amended, 15 U.S.C. 78j(b) and Rule 10b-5 thereunder, 17 CFR §240.10b-5 through use of jurisdictional means, by selling, or by offering and agreeing to sell, securities of Equity Funding Corporation of America for their clients on the basis of material, non-public inside information concerning allegations of fraud at Equity Funding obtained from Respondent Raymond L. Dirks and others without disclosing such inside information to purchasers, potential purchasers, or the investing public.

(2) During March of 1973, as more particularly found above, Respondent Raymond L. Dirks wilfully aided and abetted violations of Section 17(a) of the Securities Act by Respondents mentioned in paragraph (1) next above and wilfully violated

and wilfully aided and abetted violations by such Respondents of Section 10(b) of the Exchange Act of 1934 and Rule 10b-5 thereunder, through use of jurisdictional means, by receiving and obtaining and selectively disclosing to said Respondents and to others material, non-public inside information concerning allegations of fraud at Equity Funding.

III

THE PUBLIC INTEREST

In determining what sanctions, if any, it is appropriate to apply in the public interest, it is necessary for the Commission, among other factors, to ". . . weigh the effect of . . . action or inaction on the welfare of investors as a class and on standards of conduct in the securities business generally." 63/

It does not appear that any of the Respondents has been the subject of prior disciplinary action. The principals of the selling respondents, and the firms themselves, enjoy good reputations. All selling respondents have incurred substantial legal costs, some significantly greater than others, in connection with defending this proceeding, and in private litigation, including both individual suits and class actions. The Boston

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63/ Arthur Lipper Corporation, Securities Exchange Act Release No. 11773 (October 24, 1975) 8 SEC Docket 273, 281. Atlhough the reviewing Court in Arthur Lipper Corp. v. S.E.C., 547 F.2d 171, 184-5 (2d Cir. 1976) reduced the Commission's sanctions on its view of the facts, it recognized that deterrence of others from violations is a legitimate purpose in the imposition of sanctions.

Company, parent of III and Bristol & Co., incurred some $3.5 million in legal and related costs as a result of its Equity Funding involvement, of which 45% was allocated to Bristol & Co. and the balance to other subsidiaries. Class actions in the United States District Court arising out of the Equity Funding situation were settled for $60 million, toward which certain of the selling respondents, including Dreyfus, contributed $4 million.

Certain respondents urge that they lost customers and business that they have never recovered, but proof that this resulted from their having traded Equity Funding securities is not adequately established.

The Boston Company, parent of III and Bristol & Co., has a new chief executive officer who, in his testimony at the hearing, conveyed an impression of special sensitivity to proper recognition of the public investors' rights in matters such as insider trading.

Dreyfus states in its brief, and this is accepted as established for the purpose of assessing sanctions, that it has introduced an improved and effective system of compliance, including procedures for making counsel readily available to persons in the firm having to make transaction decisions that could involve inside information problems.

As to Dreyfus, account is also taken of the fact that

although it did not disclose to Goldman, Sachs, all of the material, inside information it received, or make overall legally effective disclosure, it did disclose a significant amount of inside information to Goldman, Sachs. While Dreyfus had no legal basis for assuming it had made proper disclosure, its failure to make full disclosure is perhaps more understandable in light of the partial disclosure that was made and of the overall circumstances involving its transaction.

The argument made by several respondents that no sanction should be applied because of the Division's effort at "selective enforcement" is not accepted. There is no basis in the record for concluding that the Division or the Commission improperly selected Respondents to be proceeded against while failing to include others equally culpable.

Respondent Dirks was less than candid in his testimony in this proceeding, particularly as respects the degree of his alleged disbelief of the allegations of fraud at EFCA at various stages of his investigation. Moreover, in suggesting that his investigation and selective dissemination of the allegations of fraud at EFCA were just a part of his normal functions as an insurance company analyst, Dirks evidences a lack of appreciation for the fundamental purpose underlying the insider trading rule. And, as the findings indicate, Dirks was an indispensable and knowing actor in the violations committed by the selling respondents. Dirks's argument that he should be given credit for having "exposed" the EFCA fraud has already been discounted in the findings above, in view of his mixed motives.

Dirks urges that as a result of his Equity Funding investigation he was fired from his job and kept out of his profession for about a year. Although he so testified, at other points in the record it appears that he may have taken a year off to write a book concerning his exposé. At any rate, he has not had difficulty obtaining a number of employments in the securities industry since that time. Dirks also claims he was thwarted in his efforts to become a registered investment adviser by "threats" that an administrative proceeding would be immediately mounted against him if he applied for registration.

In overall terms, the record indicates that on the whole Dirks sustained less (if any) financial loss or loss of reputation as a result of his involvement with the Equity Funding matter than did the selling respondents. And, of equal significance, selling respondents appear to have learned more from the experience in terms of future caution than has Dirks.

Taking into account the nature and extent of the violations, mitigating circumstances, and the record as a whole, it is concluded that the sanctions ordered below both for remedial and deterrent purposes are necessary, appropriate and adequate in the public interest.

IV

ORDER

Accordingly, IT IS ORDERED as follows:

(1) Respondent Raymond L. Dirks is hereby suspended from association with a broker or dealer for a period of sixty days.

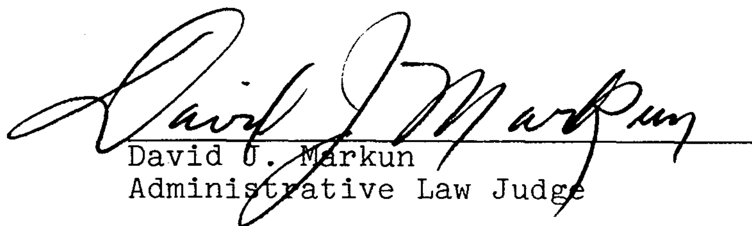
(2) Respondents The Boston Company Institutional Investors, Inc., John W. Bristol & Co., Inc., Manning & Napier, and Tomlin, Zimmerman & Parmelee, Inc. are hereby censured.

(3) The imposition of a sanction is not deemed to be necessary in the public interest in the case of Respondent The Dreyfus Corporation.

This order shall become effective in accordance with and subject to Rule 17(f) of the Commission's Rules of Practice, 17 CFR §201.17(f).

Pursuant to Rule 17(f), this initial decision shall become the final decision of the Commission as to each party that has not, within fifteen (15) days after service of this initial decision upon him or it, filed a petition for review of this initial decision pursuant to Rule 17(b), unless the Commission, pursuant to Rule 17(c), determines on its own initiative to review this initial decision as to him or it. If a party timely files a petition for review,

or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party. 64/



David J. Markun
Administrative Law Judge

Washington, D.C.
September 1, 1978

64/ All proposed findings, conclusions, and supporting arguments of the parties have been considered. To the extent that the proposed findings and conclusions submitted by the parties, and the arguments made by them, are in accordance with the findings, conclusions and views stated herein they have been accepted, and to the extent they are inconsistent therewith they have been rejected. Certain proposed findings and conclusions have been omitted as not relevant or as not necessary to a proper determination of the material issues presented. To the extent that the testimony of various witnesses is not in accord with the findings herein it is not credited.