

INVESTMENT COMPANIES AND INSIDE INFORMATION

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Investment companies¹ are in business to optimize the interests of their shareholders; thus the prime responsibility of their managers is to supervise investment portfolios in a manner calculated to achieve this goal. Because the persons responsible for investment decisions are always in the market for corporate information, they may occasionally find themselves in possession of significant facts regarding an issuer which are not publicly known. This article discusses the principal methods in which investment companies have access to such information and analyzes the elements which give rise to an affirmative duty of disclosure before the information may be acted upon.

As shareholders in portfolio companies, most investment companies have consciously chosen an inactive role as the policy best suited to furthering the interests of their own shareholders.² The choice is generally influenced by the fact that involvement in portfolio company affairs can create conflicts of interest and restrict investment decision-making.³ Thus investment companies traditionally have carefully limited the character of their relationships with portfolio companies. As a result, the number of reported instances of investment

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¹ Throughout this article the term "investment company" refers to a company which falls within the definition contained in § 3(a) of the Investment Company Act of 1940, 15 U.S.C. § 80a-3(a) (1964), as amended, 84 Stat. 1413 (1970).

The term means, in brief, an issuer engaged in the business of investing or trading in securities, or one that owns or holds investment securities having a value exceeding 40% of its total assets. See Ganett, *When Is An Investment Company?*, 37 U. Det. L.J. 355 (1960); Kerr, *The Inadvertent Investment Company: Section 3(a)(3) of the Investment Company Act*, 12 Stan. L. Rev. 29 (1959); Kerr and Appelbaum, *Inadvertent Investment Companies—Ten Years After*, 25 Bus. Lawyer 887 (1970) for a discussion of the technical problems involved in identifying investment companies.

For comprehensive discussions of investment companies generally, see A. Stevenson, *Shares in Mutual Investment Funds* (1946); H. Bullock, *The Story of Investment Companies* (1959); Investment Company Institute, *Management Investment Companies* (1962); Investment Company Institute, *The Money Managers* (1967).

² In 1962, the Wharton School of Finance and Commerce reported that, considering the size of their holdings, open-end investment companies are relatively inactive shareholders who tend to give uncritical support to existing management. House Comm. on Interstate and Foreign Commerce, *A Study of Mutual Funds*, Prepared for the Securities and Exchange Commission by Wharton School of Finance and Commerce, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 26 (1962) [hereinafter cited as *Wharton Report*]. The Wharton Report indicated that this attitude was common among institutional investors. *Id.* See Report of the Securities and Exchange Commission, *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 310-11 (1966) [hereinafter cited as *PPI*].

³ Wharton Report, *supra* note 2, at 26 and 417-20.

companies participating in proxy fights and tender offers, advising management on business matters, or bringing suits to redress wrongs to shareholders is quite small.⁴ When an investment company loses confidence in the management of a portfolio company, it usually liquidates its holdings in the latter, rather than voting its shares for change in corporate management or policy.

Investment company reluctance to become involved in the management or policy-making of portfolio companies does not result from any of the proscriptions of the Investment Company Act of 1940 (1940 Act). The 1940 Act imposes no significant restrictions on activities of investment companies unless the portfolio company happens to be an "affiliated person."⁵ Moreover, the drafters of the 1940 Act indicated that investment companies should not be discouraged from participating actively in the affairs of the companies in which they invested.⁶ In fact, the staff of the Securities and Exchange Commission

⁴ Id. at 424-27; PPI, *supra* note 2, at 308-10.

⁵ Investment companies may not invest in companies having any significant broker-dealer, investment advisory or underwriter operations. 15 U.S.C. § 80a-12(d)(3) (1970) and 17 C.F.R. § 270.12d-1 (1971). Nor may they acquire more than 10% of the total outstanding voting stock of any insurance company. Id. § 80a-12(g). Investment companies are also prohibited from purchasing any voting securities of a company if "circular ownership" or "cross-ownership" exists or will result from such purchase. Id. § 80a-20(c).

No such restrictions are placed on other institutional investors. Institutional Investor Study Report of the Securities and Exchange Commission, H.R. Doc. No. 92-64, pt. 5, 92d Cong., 1st Sess. 2542-49 (1971) [hereinafter cited as SEC Institutional Investor Study].

The Senate and House Reports on the 1940 Act and the Investment Advisers Act of 1940 contain section-by-section summaries. S. Rep. No. 1775, 76th Cong., 3d Sess. (1940); H.R. Rep. No. 2639, 76th Cong., 3d Sess. (1940). For discussions of the 1940 Investment Company Act by lawyers who represented groups of investment companies at the Senate and House hearings and who participated actively in the negotiations leading to the agreement with respect to the legislation and in drafting the 1940 Act in its final form, see Jaretzki, *The Investment Company Act of 1940*, 26 Wash. U.L.Q. 303 (1941); Motley, Jackson & Barnard, *Federal Regulation of Investment Companies Since 1940*, 63 Harv. L. Rev. 1134 (1950).

The Senate and House Reports on the Investment Company Amendments Act of 1970, Act of Dec. 14, 1970, Pub. L. No. 91-547, 84 Stat. 1413 [hereinafter cited as 1970 Amendments Act] contain section-by-section summaries of the 1940 Act's only major revisions. S. Rep. No. 184, 91st Cong., 2d Sess. (1969); H.R. Rep. No. 1382, 91st Cong., 2d Sess. (1970). See North, *History of Federal Investment Company Legislation*, 44 Notre Dame Lawyer 677 (1969) on the history of federal investment company legislation prior to 1969, and North, *The Investment Company Amendments Act of 1970*, 46 Notre Dame Lawyer 712 (1971) for a discussion of the history and substantive provisions of the 1970 Amendments Act.

⁶ While the SEC, since 1940, has required investment companies to establish and disclose to investors their policies with respect to involvement in the affairs of portfolio companies, it has never suggested restricting involvement. The original SEC bill, S. 3580, 76 Cong., 3d Sess. (1940), contained a § 8(b)(1)(B) which would have required investment companies to describe in their registration statement

the activities other than investment in which the registrant is engaged and proposes to engage, such as trading, underwriting, acting as investment adviser, and participating in or influencing the management of companies' outstanding securities which are held by the registrant.

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(SEC), at the time it drafted the original bills, specifically argued that investment companies were ideally suited to pursue and protect the best interests of *all* small investors, as well as those of their own shareholders:

Investment companies may serve the useful role of representatives of the great number of inarticulate and ineffective individual investors in industrial corporations in which investment companies are also interested. Throughout the course of the existence of such industrial corporations, various problems are presented to their stockholders which require a degree of knowledge of financial and management practices not possessed by the average stockholder. Investment companies by virtue of their research facilities and specialized personnel are not only in a position to adequately appraise these situations but also have the financial means to make their support or opposition effective. These investment companies can perform the function of sophisticated investors, disassociated from the management of their portfolio companies. They can appraise the activities of the management critically and expertly, and in that manner not only serve their own interests but the interest of the other public stockholders.⁷

Even diversified investment companies were allowed to become involved with portfolio companies.⁸ Thus the restriction against their

Hearings on S. 3580 Before a Subcomm. of the Comm. on Banking and Currency, 76th Cong., 3d Sess. 6 (1940). This provision was deleted, without discussion, during the congressional hearings. Following enactment of the 1940 Act, however, the SEC adopted Form N-8B-1 for use by management investment companies in preparing registration statements filed under § 8(b). Item 38(a) of Form N-8B-1 required a description "of the policy of the registrant with respect to investments in companies for the purpose of exercising control or management." The item was renumbered 5(d) in 1954 but was left unchanged. Most investment companies respond to this item by stating that their policy is not to invest for the purpose of exercising control or management. SEC Institutional Investor Study, *supra* note 5, at XXXI. At present the SEC has under consideration proposals which would substantially expand the requirements for statements of policies of investment companies on their involvement in the affairs of their portfolio companies. Investment Company Act Release No. 6853 (Dec. 1, 1971), [Current] CCH Fed. Sec. L. Rep. § 78,432 (1971).

⁷ Report of the Securities and Exchange Commission, Investment Trusts and Investment Companies, H.R. Doc. No. 707, 75th Cong., 2d Sess. (1939). The Investment Trust Study, made pursuant to § 30 of the Public Utility Holding Company Act of 1935, 49 Stat. 803, 15 U.S.C. §§ 79a et seq. (1970), took about 4 years to complete and involved the study of 1,272 trusts and companies for the years 1927-35. Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess., pt. 1, at 39 (1940).

⁸ Open-end and closed-end management investment companies are divided by the Investment Company Act into "diversified" and "nondiversified" companies, the latter being a residual class which includes all companies not included in the first. 15 U.S.C.

acquiring more than ten percent of the outstanding voting securities of portfolio companies was not applied to a twenty-five percent "reservoir" of their total assets.⁹

I. INVESTMENT COMPANY ACCESS TO INFORMATION

While they have avoided direct involvement in portfolio company affairs, investment companies have, however, exerted their influence to establish information "pipe lines" with the management of these portfolio companies. The Wharton Report found that all but a few of the open-end investment companies studied had engaged in private personal contacts such as "frequent visits, telephone calls, correspondence and occasional get-togethers at the annual meeting of the portfolio company or at the offices of the investment company."¹⁰ The Report found further that the character and extent of these communications were directly related to the size of the investment company; the larger companies reported a greater frequency of field trips and private meetings for purposes of obtaining information.¹¹

Usually, financial analysts¹² employed by the investment com-

§ 80a-5(b) (1970). A diversified company must at all times have at least 75% of the value of its total assets represented by (a) securities limited in respect of any one issuer to an amount not greater in value than 5% of the value of the total assets of the diversified company and to not more than 10% of the outstanding voting securities of the issuer, and (b) cash and cash items (including receivables), U.S. Government securities, and securities of other investment companies. *Id.* § 80a-5(b)(1).

The restrictions against making purchases that would result in an investment company having more than 5% of its total assets invested in the securities of one issuer or owning more than 10% of the outstanding voting securities of one issuer were not new with the 1940 Act. The Revenue Act of 1936, § 48c, 49 Stat. 1669, amending the Internal Revenue Act of 1928, first adopted the tests for the 1936 Act's definition of "mutual investment company," but applied them to 100% of an investment company's assets. In 1942, the 1936 Revenue Act test was loosened and the restrictions were applied only to 50% of assets. Revenue Act of 1942, § 170(a), 56 Stat. 878, amending the Int. Rev. Code of 1939, 53 Stat. 1. This provision remains in effect today. Int. Rev. Code of 1954, § 851(b)(4). A number of states, however, have incorporated the restrictions into their blue-sky statutes and regulations; and they continue to apply them to 100% of the assets of any company making an offering of securities within their states. See, e.g., Ohio Division of Securities Regulation Cos-1-06 (C)(i)§(j), 2 CCH Blue Sky L. Rep. ¶ 38,653 at 34,508 (1968).

⁹ The purpose of the 25% reservoir was "to stimulate the operations of the capital markets." Hearings on H.R. 10065, Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 105 (1940) [hereinafter cited as 1940 House Hearings]. "An investment company will not make a substantial investment in a small company which has no market for its securities and yet have nothing to say about management." *Id.*

¹⁰ Wharton Report, *supra* note 2, at 27.

¹¹ *Id.* at 423-24.

¹² For an analysis of the characteristics of the financial analyst, see Norby, Profile of the Financial Analyst, 24 Financial Analysts J., No. 4 at 11 (July-Aug. 1968). See also Hayes, Potential for Professional Status, 23 Financial Analysts J., No. 6 at 29 (Nov.-Dec. 1967).

pany or, if the company is externally managed, its investment adviser, will conduct the interviews and seek to establish lines of communication with the management of portfolio companies. Many investment companies attach considerable importance to impressions they derive from field visits.¹³ The president of one open-end company has stated that his company's analysts "interview ten different managements, or hold ten management interviews each working day during the year."¹⁴ In 1967 it was reported that the nine analysts of one investment adviser

travel[ed] about 450,000 miles a year in aggregate, collecting detailed data and personal insights about literally hundreds of corporations, including every one held in the portfolio of the[ir] . . . funds, for it is a house policy . . . [of this investment adviser] never to buy a security of a company unless that company has been visited first by a financial analyst.¹⁵

Investment companies also obtain information directly from issuers, usually in connection with private offerings of restricted securities¹⁶ made pursuant to Section 4(2) of the Securities Act of 1933 (1933 Act).¹⁷ Investment companies are frequently approached by issuers because of their large assets and flexible investment policies.¹⁸ More importantly, investment companies are generally safe offerees under the Supreme Court's decision in *SEC v. Ralston Purina*, which held that the private offering exemption is unavailable unless every offeree is a sophisticated investor who does not "need . . . the protection afforded by [the] registration" of securities under the 1933 Act.¹⁹ Since transactions exempt from the registration requirements are not exempt from any of the fraud provisions of the federal securi-

¹³ PPI, *supra* note 2, at 85-86.

¹⁴ University of Pennsylvania Law School Conference on Mutual Funds, *Mutual Funds as Investors of Large Pools of Money*, 115 U. Pa. L. Rev. 669, 723 (1967).

¹⁵ Investment Company Institute, *The Money Managers* 85-86 (1967). This book, which was authored by the national association of the mutual fund industry, contains an excellent description of the structure and operation of a large investment advisory firm and a field visit by one of its financial analysts. *Id.* at 73-86.

¹⁶ Rule 144 under the Securities Act of 1933, 15 U.S.C. §§ 77a-aa (1964), defines the term "restricted securities" to mean "securities acquired directly or indirectly from the issuer thereof, or from an affiliate of such issuer, in a transaction or chain of transactions not involving any public offering." Securities Act Release No. 5223 (Jan. 11, 1972), [Current] CCH Fed. Sec. L. Rep. ¶ 78,847. See note 29 *infra*.

¹⁷ 15 U.S.C. § 77d(2) (1970): "The provisions of section 77e of this title shall not apply to . . . (2) transactions by an issuer not involving any public offering."

¹⁸ See Investment Company Act Release No. 5847 (Oct. 21, 1969), 4 CCH Fed. Sec. L. Rep. ¶ 72,135.

¹⁹ *SEC v. Ralston Purina*, 346 U.S. 119, 127 (1953).

ties laws,²⁰ an issuer must furnish investment companies which purchase restricted securities with all material information.²¹ In addition, the Supreme Court stated in *Ralston Purina* that the test for the availability of the private offering exemption is whether the offerees are in such a position with respect to the issuer as to have "access to the kind of information which registration would disclose."²² Consequently, issuers of privately placed securities often give investment companies with restricted securities holdings information not generally available to the public before and after the private sale.²³

Information of the type obtained through contacts with officers of portfolio companies is also indirectly provided through brokerage firms.²⁴ In addition to their own analysts, brokerage firms have access to information through avenues not open to investment companies.²⁵ News and other impressions can be carried to the institutional salesmen by way of the firm's syndicate department or by a principal or associate in the firm who happens to be an officer or director of a portfolio company.²⁶ In general, the same supplemental research and advisory materials furnished by brokerage firms to investment companies are furnished to their other customers.^{26a} However, it is axiomatic

²⁰ Securities Act of 1933, §§ 11, 17, 15 U.S.C. §§ 77k, g (1970); Securities Exchange Act of 1934, §§ 9, 10, 18, 15 U.S.C. §§ 78i, j, r (1970).

²¹ See *The Crowell-Collier Publishing Co.*, [1957-1961 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 76,539; Securities Act Release No. 5226 (Jan. 10, 1972) [Current] CCH Fed. Sec. L. Rep. ¶ 76,539 (1972).

²² 346 U.S. at 127 (emphasis added).

²³ For example, purchase agreements relating to restricted debt securities frequently require the issuer to provide the owners of the restricted securities with interim unaudited financial statements.

²⁴ PPI, *supra* note 2, at 85, 163-64.

²⁵ The depth of research on which brokerage firms base their investment advice varies considerably from firm to firm. SEC, Report of the Special Study of the Securities Markets, H.R. Doc. No. 95, pt. 1, 88th Cong., 1st Sess. 344-58 (1963) [hereinafter cited as Special Study].

²⁶ *Investors Management Co.*, [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,832, Hearing Examiner's initial decision affirmed by the Commission, [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 (1971). *Van Alstyne, Noel & Co.*, [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,656 (1969); *Blyth & Co.*, [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,647 (1969); *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961); *Black v. Shearson, Hammill & Co.*, 72 Cal. Rptr. 157 (Ct. App. 1968).

^{26a} See Welles, *How the Street is Putting the Little Man Out of the Market*, Inst. Inv. 37 (March, 1972). The author quotes the director of investment policy for a major brokerage firm as stating that the firm's salesmen are "reprimanded" . . . if they disseminate certain research information too widely among small investors. "Giving it to everyone downgrades the quality of the work. . . . It cheapens it." *Id.* at 92-93.

In its recent policy statement on the Future Structure of the Securities Markets, 4 CCH Fed. Sec. L. Rep. ¶ 74,811 (February 2, 1972) the SEC indicated that such a practice may be improper:

We believe that a broker is obliged to communicate any material changes in his prior investment advice arising from subsequent research he may do to all customers whom he knows have purchased and may be holding shares on the basis of

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that investment companies and other institutional investors receive more and better services; for it is a fact of life that useful information is a valuable piece of property that is first passed around to those able to pay the most for it.²⁷

Although direct contacts continue to be a useful investment tool because of the first-hand impressions of management they provide, access to corporate management is important today for another reason. Primarily as a result of specific recommendations contained in the Wheat Report,²⁸ the reporting requirements for issuers have been greatly expanded and incentives have been established to encourage reporting of information by companies not otherwise required to do so.²⁹ As more detailed and sophisticated data is reported by issuers,

his earlier advice, at least under circumstances where to do so would not impose an unreasonable hardship on the broker.

Id. at 65,620. Characterizing the Commission's statement as "the bare minimum standard in this area," one Commissioner has said that "we feel a prompt and fair dissemination to large and small investors alike is indispensable to the efficiency of the securities market." The Public: We Need Them, Address by Hugh F. Owens, Commissioner of the SEC., Texas District Securities Industry Association, Dallas, Texas, April 10, 1972, at 2.

²⁷ "The advisory and other services that brokerage firms customarily provide without separate charge constitute a part of the compensation for investor patronage." PPI, *supra* note 2, at 164. The advisory contracts of many investment advisers expressly or impliedly authorize use of brokerage commissions for "corroborative" research to supplement the advice purchased by advisory fees. See SEC Rate Structure Investigation of the National Securities Exchanges, File No. 4-144 at 779, 827-28, 1800, 2116 (1968-1969); Robards, Do Brokers Give Better Advice to Institutions?, N.Y. Times, Dec. 5, 1971, § 3 at 2, col. 1. The SEC on a number of occasions in the past year has indicated its concern over the difference in treatment between small and large investors. See address by William J. Casey, Chairman of the Securities and Exchange Commission, before the Investment Bankers Association of America, in Boca Raton, Florida, Dec. 1, 1971, SEC News Release (Dec. 8, 1971); SEC Statement of Policy, The Future Structure of the Securities Markets (Feb., 1972). See also the SEC's Order for Public Proceedings, Butcher & Shererd, SEC Administrative Proceeding, File No. 3-3396 (Nov. 24, 1971).

²⁸ Disclosure to Investors: A Reappraisal of Administrative Policies under '33 and '34 Acts, Report of Disclosure Policy Study (1969).

²⁹ Securities Exchange Act Release No. 9000 (Oct. 21, 1970), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,919; Securities Exchange Act Release No. 9004 (Oct. 28, 1970), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,920; Securities Exchange Act Release No. 9005 (Nov. 2, 1970), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,922; Securities Exchange Act Release No. 9253 (July 19, 1971), 4 CCH Fed. Sec. L. Rep. ¶ 72,143; Securities Exchange Act Release Nos. 9442 & 9443 (Jan. 10, 1972), [Current] CCH Fed. Sec. L. Rep. ¶ 78,486. Under the Securities Exchange Act of 1934, 15 U.S.C. § 78a-jj, certain issuers were not required to file reports under §§ 13 or 15(d), 15 U.S.C. §§ 78m and 78o(d); however, they are now under some pressure to register under § 12(g) and thereby voluntarily subject themselves to the reporting requirements of § 13 of the 1934 Act, or alternatively, to make publicly available substantially similar information in order to permit holders of their restricted securities to sell them under recently adopted Rule 144 of the 1933 Act. The Rule 144 provisions are also intended to encourage more extensive company reporting. Securities Act Release No. 5223 (Jan. 11, 1972), in which the SEC adopted Rule 144, states:

If the issuer does not file reports pursuant to Sections 13 or 15(d) of the Exchange Act, such persons should consider obtaining an agreement by the issuer to register voluntarily under that Act so that Rule 144 may be available.

it becomes increasingly more important that their officers be available to explain its significance. In this framework, financial analysts clearly have a necessary role. Portfolio managers, investment committees, securities salesmen and individual investors can hope to obtain and assimilate very little of the information accumulating in public files and being reported in the financial press. The task must be delegated to information middlemen who have enough ability and time to keep informed of developments in specialized areas and enough access to corporate management to develop complete and accurate analyses of the investment values of large numbers of companies.³⁰

II. THE DEVELOPMENT OF RULE 10b-5 AND ITS EFFECT ON INVESTMENT COMPANIES

Until recently, investment companies and other financial institutions enjoyed unrestricted access to top management. It was generally believed that any information ferreted out by a resourceful analyst was available for use in any manner he desired.³¹ Moreover, many corporate insiders unhesitatingly passed on even clearly material, non-public information to friends and associates or acted on it them-

³⁰ The importance of unrestricted access to corporate management has been universally recognized. See Gearhart, *Corporate Management and the Analysts*, 23 *Financial Analysts J.* No. 5, at 31 (Sept.-Oct. 1967); Disclosure: The SEC and the Press, Address by Manuel F. Cohen, Chairman of the SEC, Univ. of Connecticut, C. M. Loeb Awards Luncheon, in New York City, May 21, 1968; Address by William J. Casey, Chairman of the SEC, before the Institutional Trading Conference, in New York City, June 17, 1971, at 9-11; Address by William J. Casey, Chairman of the SEC, before the Conference Board, in New York City, Nov. 18, 1971 at 5-7. See also New York Stock Exchange Company Manual, § A2, at A-18 to A-20 (1968); American Stock Exchange Company Guide, pt. 4, at 108 (Apr. 15, 1968).

³¹ Even today the Financial Analysts Federation, the national association of financial analysts societies, does not specifically prohibit the seeking or using of material, nonpublic corporate information in its Code of Ethics and Standards of Professional Conduct. The Standards of Professional Conduct provide only that "[t]he financial analyst shall have and maintain knowledge of and shall comply strictly with all federal, state and provincial laws as well as with all rules and regulations of any governmental agency governing his activities." The Financial Analysts Federation, 1972 Membership Directory 32 (1972).

On October 3, 1968, shortly after the SEC announced public administrative proceedings against the financial institutions named as respondents in *Investors Management Co.*, [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,832 (1970), and the Court of Appeals for the Second Circuit announced its decision in the SEC's suit against Texas Gulf Sulphur, *SEC v. Texas Gulf Sulphur*, 407 F.2d 453 (1968), the President of the Financial Analysts Federation stated that "analysts should continue to seek substantive, but not privileged information by all appropriate means." Bissell, *Corporate Disclosure and Inside Information*, 24 *Financial Analysts J.* No. 6, at 9 (Nov.-Dec. 1968). The statement was prompted by a concern, held by many analysts, that the two developments would result in issuers initiating a "closed-doors" policy. For the SEC's reply to the expressions of concern, see Address by Manuel F. Cohen, Chairman of the SEC, Meeting of North American Securities Administrators, in Bar Harbour, Florida, Oct. 8, 1968; see also Address by Manuel F. Cohen, Chairman of the SEC, Univ. of Connecticut, C. M.

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selves.⁸² It was thought that, except in certain extraordinary cases, Section 16(b) of the Securities Exchange Act of 1934 was the only restriction on use of inside information.⁸³ During the 1955 public hearings by the Senate Committee on Banking and Currency on the stock

Loeb Awards Luncheon, New York City, May 21, 1968.

Interestingly enough, however, many local financial analysts' associations have their own closed-door policies. They refuse to permit members of the public or press to attend their meetings with corporate officials. See Newman, *Analysts' Closed Talks with Firms Are Called Unfair by Press*, Wall Street Journal, March 31, 1972, at 1, col. 1; Stabler, *New Strictures Prompt Firms to Revise Policies on Disclosure of News*, Wall Street Journal, Oct. 9, 1968, at 1, col. 6.

⁸² See Stabler, *New Strictures Prompt Firms to Revise Policies on Disclosure of News*, Wall Street Journal, Oct. 9, 1968, at 1, col. 6; Green, *SEC Sees Court Rulings on 'Insider' Trading Changing Brokers' Method of Operations*, Wall Street Journal, Sept. 3, 1968, at 30, col. 1; Wall Street Journal, Aug. 16, 1968, at 1, col. 6.

In a 1962 survey of "reputable" businessmen, 42% indicated that they would trade on inside information and 61% believed that the "average" investor would do likewise. Baumhart, *How Ethical are Businessmen*, Harv. Bus. Rev., July-Aug., 1961, exhibit II at 16. The question to which these responses were given was: "Imagine that you are a member of the board of directors of a large corporation. At a board meeting you learn of an impending merger with a smaller company which has had an unprofitable year, and whose stock is presently selling at a price so low that you are certain it will rise when news if the merger becomes public knowledge." Merrill Lynch, Pierce, Fenner & Smith, Inc., after being charged by the SEC staff in the Investors Management proceedings with passing on to a small number of favored institutional customers material inside information obtained as the prospective managing underwriter of a proposed public offering, mailed to all of its customers a letter dated Aug. 28, 1968, which stated: "[W]e do not believe we have done anything wrong or anything that violates the ethical principles on which we have always sought to do business." (A copy of the letter is on file in the Boston College Industrial and Commercial Law Review Office).

⁸³ 15 U.S.C. § 78p(b) (1970). The surprise expressed by many persons in the securities business at the reach of the holdings in SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968), and Investors Management Co. [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,832 (1970), aff'd by the Commission, [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 (1971), has been chronicled by many publications. See, e.g., The Law: Trouble for the Top, Forbes, Sept. 1, 1968, at 23; Birmingham, *The Texas Gulf Sulphur Case, Trusts and Estates*, Oct. 1968, at 927; Landau, *The Inside Information Controversy and Its Impact*, Inst. Inv., Dec. 1968, at 31.

Section 16(b) applies only to officers, directors and persons who are direct or indirect beneficial owners of more than 10% of a class of equity securities and is generally referred to as the "insider trading" provision of the federal securities laws. See 2 L. Loss, *Securities Regulations* 1037-1132 (2d ed. 1961). It is a remedial provision which permits a corporation, or a stockholder on the corporation's behalf, to recapture any profit realized by such insiders from short-swing trading in the corporation's equity securities. The pertinent part provides:

(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months.

15 U.S.C. § 78p(b) (1970).

market, the president of the National Association of Securities Dealers (NASD) confirmed, without qualification, the accuracy of the statement that "[t]here is absolutely no prohibition on insider trading in the over-the-counter markets."⁸⁴

Since the 1955 hearings, the SEC and the federal courts⁸⁵ have established that the prohibitions of Section 10(b)⁸⁶ of the 1934 Act

⁸⁴ Hearings on Factors Influencing the Buying and Selling of Equity Securities Before the Senate Comm. on Banking and Currency, 84th Cong., 1st Sess. 344 (1955). Two weeks later, at the same hearings, the Chairman of the SEC was questioned by the Committee's Staff Director regarding proscriptions against the use of inside information; the following colloquy, remarkable by today's standards, was recorded:

MR. WALLACE. Mr. Chairman, there are certain regulations now with respect to insider trading on a 6-month basis, the profits of which would be recoverable by the corporation or a stockholder. Is it illegal for the officer to divulge inside information to anybody else to use for the basis of trading?

MR. DEMMLER. I think that is a hypothetical question which I could not answer. It would all depend on the circumstances.

MR. WALLACE. I cannot see that a question as to the legality of divulging inside information is hypothetical. As I understand it, on this insider trading proposition there is no regulation on unlisted securities?

MR. DEMMLER. Except for rule X-10B-5 and section 17 of the Securities Act.

MR. WALLACE. But those provisions relate to fraud, not insider trading. So that an officer or director would have everything to gain and nothing to lose by participating on insider trading, since all he could lose would be the profits, and there are no criminal penalties?

MR. DEMMLER. Well, he also pays a tax on the profits and gets the profits taken away, so he loses the profits plus the tax.

MR. WALLACE. He would lose the tax on the profits, too?

MR. DEMMLER. I think I am correct in my statement of the tax law. So it is not correct to say he has everything to gain and nothing to lose.

MR. WALLACE. So all he has to lose is the tax on his profits?

MR. DEMMLER. He has the tax on his profits to lose and, of course, it probably costs him something to defend the action.

MR. WALLACE. And there is no illegality in disclosing any inside information to anyone?

MR. DEMMLER. I did not say that. I said that would depend on the circumstances, Mr. Wallace.

MR. WALLACE. Well, you mentioned rule X-10B-5 and section 17 of the Securities Act. Were you not talking about fraudulent action or betraying of trust of the corporation?

MR. DEMMLER. Well, I can conceive of all kinds of imaginative situations in which it might be illegal. I can conceive of other situations in which the statute would not have been violated in any way. You may have questions of State law involved. It is just too hypothetical a question to answer.

Id. at 964-65. Not unexpectedly, similar views were expressed by officers of institutional investors. Id. at 536.

⁸⁵ Actions for violations of the 1934 Act must be brought in federal court, 15 U.S.C. § 78aa (1970).

⁸⁶ 15 U.S.C. § 78j(b) (1970) provides, in part:

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—

...

(b) To use or employ, in connection with the purchase or sale of any

and Rule 10b-5 thereunder⁸⁷ do extend to trading by corporate insiders in the over-the-counter markets and much more, as well. In *Cady, Roberts & Co.*,³⁸ the first³⁹ of the three significant cases to develop the applicability of Rule 10b-5 to "tippees,"⁴⁰ an employee of a brokerage firm who was also a director of Curtiss-Wright Corporation disclosed to one of the firm's partners that Curtiss-Wright had just decided to reduce its quarterly dividend. Realizing that the news had not yet been carried by news services, the partner immediately sold shares of Curtiss-Wright for his wife and a number of discretionary accounts. Although the partner was not an "insider" in the traditional sense,⁴¹ the SEC found that he had violated Rule 10b-5, and suspended his membership in the New York Stock Exchange.⁴² The SEC reached this result by establishing a broad definition of insider, premised on a "special relationship" which gives a person direct

security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

⁸⁷ 17 C.F.R. § 240.10b-5 (1971) provides:

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 security exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) 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

(c) 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.

³⁸ *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

³⁹ Even prior to 1955, a violation of Rule 10b-5 was found where a majority stockholder had purchased stock from minority stockholders without disclosing that the value of the issuer's tobacco inventory had greatly appreciated from the cost figure shown on the issuer's books. *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951). In a previous case brought on the same set of facts, it was held that the defendant's conduct did not amount to common law fraud because no fraudulent misrepresentation had been made. *Geller v. Transamerica Corp.*, 55 F. Supp. 625 (D. Del. 1943).

⁴⁰ The term "tippee" refers to a person who receives a "tip," generally information which has not been made public. The term was probably first used by Professor Loss. See 3 L. Loss, *Securities Regulation* 1451 (2d ed. 1961).

⁴¹ Section 16(b) of the 1934 Act, 15 U.S.C. § 78p(b) (1970), generally referred to as the "insider trading" provision, applies only to officers, directors and persons who are the direct or indirect beneficial owners of more than 10% of a class of equity security. See 2 L. Loss, *Securities Regulation* 1037-1132 (2d ed. 1961). In *Cady, Roberts* the SEC acknowledged that the "affirmative duty to disclose material information has been traditionally imposed on corporate 'insiders,' particularly officers, directors, or controlling stockholders." 40 S.E.C. at 911.

⁴² 40 S.E.C. at 917-18. The associate died in 1960 and was not a respondent in the proceedings. *Id.* at 909.

or indirect access to corporate information.⁴³ The SEC had no difficulty finding that the Cady, Roberts partner, by virtue of his relationship to the Cady, Roberts employee who was a director of Curtiss-Wright, fell within this group of "access" insiders.⁴⁴

The second, and undoubtedly most important, case in the development of Rule 10b-5 is *SEC v. Texas Gulf Sulphur Co.*⁴⁵ The case involved a mineral find in Timmins, Ontario, by engineers of the Texas Gulf Sulphur Co. On April 12, 1964, Texas Gulf officials acted to subdue stock-market rumors that the company had discovered a rich copper lode. The company issued a press release describing its mineral research in the area as merely "a prospect" and reported that circulating rumors were "premature and possibly misleading."⁴⁶ Four days later the company issued a second release announcing a major copper strike at Timmins.⁴⁷ In its suit, the SEC charged that the company had violated Rule 10b-5 when it issued a press release which it knew, or should have known, was materially misleading. The SEC also charged that between November 12, 1963, when the results of the first

⁴³ Former Chairman William L. Cary indicated that:

Analytically, the obligation rests on two principal elements; first, the existence of a *relationship giving access*, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the *inherent unfairness* involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. Thus our task here is to identify those *persons who are in a special relationship with a company and privy to its internal affairs*, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited.

⁴⁰ S.E.C. at 912 (emphasis added).

⁴⁴ The facts here impose on . . . [the partner] the responsibilities of those commonly referred to as "insiders." He received the information prior to its public release from a director of Curtiss-Wright . . . who was associated with the registrant. . . . [The director's] relationship to the company clearly prohibited him from selling the securities affected by the information without disclosure. By logical sequence, it should prohibit Gintel, a partner of the registrant.

Id. at 913.

⁴⁵ 401 F.2d 833 (2d Cir. 1968) cert. denied sub nom., *Coates v. SEC*, 394 U.S. 976 and *Kline v. SEC*, 394 U.S. 976 (1969). *Texas Gulf Sulphur* is the most significant because of its treatment of corporate publicity as well as insider trading. In his concurring opinion, Judge Friendly commented on the corporate publicity aspect of the case as "transcending in public importance all others in this important case. . . ." 401 F.2d at 866. The court held that corporate publicity is subject to the Rule whenever it is issued "in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media. . . ." Id. at 862. This is true "irrespective of whether the insiders contemporaneously trade in the securities of . . . [the company issuing the press release] and irrespective of whether the corporation or its management have an ulterior purpose or purposes in making an official public release. . . ." Id. at 860-61.

⁴⁶ Id. at 845.

⁴⁷ Id. at 846.

test hole were examined and showed significant mineralization, and April 16, 1964, when the second press release was issued, a group of Texas Gulf officials had violated the Rule when they bought 12,100 shares of Texas Gulf stock, bought "calls"⁴⁸ on 5,200 shares and received employee options to buy 31,200 shares. The SEC further charged that some of the defendants had committed additional violations when they gave tips to friends and relatives who bought 14,100 shares and calls for another 14,100.

In an *en banc* decision, the Court of Appeals for the Second Circuit⁴⁹ sustained the SEC charges in virtually every major respect. With regard to the insider trading aspects of the case, the court reversed in part the district court and held that a corporate insider in possession of material inside information about his company "may not take 'advantage of such information knowing it is unavailable to those with whom he is dealing,' i.e., the investing public . . ."⁵⁰ He "must either disclose it to the investing public," or abstain from trading in the company's securities until it is disclosed.⁵¹ The court also unanimously held that Rule 10b-5 prohibits corporate insiders from passing inside information on to their friends, relatives or associates for use in securities transactions.⁵²

Since the SEC did not include any tippees among the individuals it sued, the Second Circuit did not specifically hold that tippees may themselves be covered by Rule 10b-5.⁵³ The opportunity to establish that principle was presented to the SEC in *In re Management Investors Co.*, the third major case under the Rule, an administrative proceeding ordered on the basis of SEC staff charges against Merrill Lynch, fourteen of its officers and salesmen and fifteen of its institutional customers.⁵⁴ The SEC staff charged⁵⁵ that in June, 1966, Merrill

⁴⁸ A call is an option which gives the holder the contractual right to buy a fixed amount of a certain stock at a fixed price within a specified time.

⁴⁹ The district court had found most of the SEC charges against Texas Gulf Sulphur unjustified and had exonerated all but two of the thirteen individual defendants. SEC v. Texas Gulf Sulphur, 258 F. Supp. 262 (S.D.N.Y. 1966).

⁵⁰ 401 F.2d at 848.

⁵¹ *Id.*

⁵² *Id.* at 843, 852.

⁵³ The court, however, did give a clear indication of its position on the matter: As Darke's "tippees" are not defendants in this action, we need not decide whether, if they acted with actual or constructive knowledge that the material information was undisclosed, their conduct is as equally violative of the Rule as the conduct of their insider source, though we note that it certainly could be equally reprehensible.

Id. at 852-53.

⁵⁴ Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC Admin. Proc. File No. 3-1680 (Aug. 26, 1968).

The 15 institutional investors included one investment company registered under the 1940 Act; two investment advisers registered pursuant to the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 to 18a (1970); four unregistered investment advisers to

Lynch, while acting as prospective managing underwriter of a proposed \$75 million offering of Douglas Aircraft Company convertible debentures, had learned that Douglas' six-month's earnings would be only twelve cents a share. Less than three weeks earlier, Douglas had published a report declaring earnings of eighty-five cents a share for the five-month period. The staff also charged that certain respondents had paid Merrill Lynch for this information with commissions on securities transactions and customer-directed "give-ups."⁵⁶ Pursuant to an offer of settlement by Merrill Lynch,⁵⁷ the SEC found that the material inside information had been passed on to favored institutional customers before it was disclosed to the public.

Although Merrill Lynch had negotiated a settlement and had agreed to the imposition of sanctions, all but one of the institutional respondents defended against the staff charges before an SEC Hearing Examiner.⁵⁸ After a hearing, the Examiner, ruling that Rule 10b-5 does extend to the conduct of tippees, found that twelve of the respondents had violated the Rule in connection with sales of approximately 153,000 shares of Douglas stock.⁵⁹ The Examiner held that no violation had occurred in the case of one respondent who was found to have had possession of the inside information but not to have made any sales of Douglas stock on the basis of that information.⁶⁰ Attributing the "respondents' blindness to . . . obligations [they owed] . . .

registered investment companies; and six private investment partnerships, so-called "hedge funds". *Id.*

⁵⁵ See SEC Order for Public Proceedings in SEC Administrative Proceeding File No. 3-1680 (Aug. 26, 1968) at 3-7.

⁵⁶ A "give-up" occurred when an executing broker surrendered a portion of his commission to another broker who did not participate in the particular transaction. See *Investors Management Co.*, [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,832; at 83,951 n.48 (June 26, 1970); SEC, Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 169-72 (1966) [hereinafter cited as PPI]. Customer-directed give-ups of the type involved in the Merrill Lynch case were prohibited on December 5, 1968. See Securities Exchange Act Release No. 8399 (Sept. 4, 1968), [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,599.

⁵⁷ As part of the settlement procedure, respondents in SEC administrative proceedings frequently consent to findings of violations of the federal securities laws without admitting any of the allegations. Based upon the offer of settlement of Merrill Lynch and its officers and salesmen, the SEC ordered Merrill Lynch's New York Institutional Sales and West Coast Underwriting Offices closed for 21 and 15 days, respectively; censured 10 of its employees; and ordered 7 of them temporarily to disassociate themselves from employment with Merrill Lynch. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,629.

⁵⁸ Like Merrill Lynch, the remaining institutional respondent submitted an offer of settlement, which the SEC accepted, providing for censure. *City Associates*, [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,599.

⁵⁹ *Investors Management Co.* [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,832. No sanctions were imposed against one respondent because it had no supervisory responsibilities over a controlled subsidiary which was censured, or against a successor corporation to another respondent which was also censured.

⁶⁰ *Id.* at 83,961.

the investing public . . . to undue self-interest," the Hearing Examiner recommended only that they be censured, due to "the fact that the record does not evidence deliberate intent by respondents to flout the law for financial gain, nor does it appear that respondents engaged in previous misconduct."⁶¹

Although none of the respondents sought Commission review of the Hearing Examiner's decision, the SEC, in an unusual move, announced that, because of the "significant implications" of the issues involved, it would on its own motion review the proceedings and express its own views.⁶² Subsequently, the SEC staff and certain respondents filed briefs with the Commission and, in somewhat of an anticlimax, the Commission affirmed the Hearing Examiner's sanctions.⁶³ The Commission's opinion is significant, nevertheless, for its statement of the elements of tippee responsibility under Rule 10b-5:

[1] that the information in question be material and [2] non-public; [3] that the tippee, whether he receives the information directly or indirectly, know or have reason to know that it was non-public and had been obtained improperly by selective revelation or otherwise, and [4] that the information be a factor in his decision to effect the transaction.⁶⁴

Like *Cady, Roberts* and *Texas Gulf Sulphur*, the *Investors Management* decision has recognized new disclosure responsibilities under section 10(b) and Rule 10(b)-5. The result of these decisions is the imposition of restrictions on conduct of investment companies that was previously regarded as being beyond the scope of the federal securities laws.

III. THE ELEMENTS OF TIPPEE RESPONSIBILITY

A. Materiality

An important limitation on the scope of Rule 10b-5 is the requirement that any misstatement or omission made be of a *material* fact.⁶⁵ The court of appeals in *Texas Gulf Sulphur* phrased the standard of

⁶¹ Id. at 83,962.

⁶² *Investors Management Co.* [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 at 80,515.

⁶³ Id. at 80,522.

⁶⁴ Id. at 80,519.

⁶⁵ The requirement that a material fact be involved was incorporated into Rule 10b-5 directly from § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1970), after which Rule 10b-5 was designed. For a description of its origin, see remarks of Milton Freeman, Conference on Codification of the Federal Securities Law, 22 Bus. Lawyer 793, 922 (1967). Materiality is one of the elements of common law deceit. W. Prosser, Torts § 108 at 718-20 (4th ed. 1971).

materiality in terms of the traditional common law tort standard, that the information might be important to a "reasonable" investor.⁶⁶ The court went on to explain that this test encompasses information that "in reasonable and objective contemplation" might affect the market price of the stock.⁶⁷ Viewing the glowing reports of the strike published at the time of the second announcement and "the importance attached to the drilling results by those who knew about it,"⁶⁸ the court stated that "[o]ur survey of the facts below conclusively establishes that knowledge of the results of the discovery hole, K-55-1, would have been important to a reasonable investor and might have affected the price of the stock."⁶⁹ In its opinion accepting Merrill Lynch's offer of settlement, however, the SEC apparently rejected the Second Circuit's standard in favor of one designed to establish "a relatively high threshold of materiality."⁷⁰ The SEC found the Douglas earnings information to be material because it "was of such importance that it could be expected to affect the judgment of investors whether to buy, sell or hold Douglas stock [and, if] generally know[n] . . . to affect materially the market price of the stock."⁷¹

The important difference between the standards enunciated by the SEC and the Second Circuit lies in their alternative, market-impact phraseology.⁷² The SEC for some time has insisted that there must

⁶⁶ See, e.g., 1 F. Harper and F. James, *Torts* 565-66 (1956); W. Prosser, *Torts* § 108 at 718-19 (4th ed. 1971).

⁶⁷ 401 F.2d at 849. The Second Circuit first formulated its standard of materiality in *List v. Fashion Park, Inc.*, 340 F.2d 457 (2d Cir. 1965), cert. denied, sub nom., *List v. Lerner*, 382 U.S. 811, where the court declared that information is material if "a reasonable man would attach importance" to it and if "in reasonable and objective contemplation [it] might affect the value of the corporation's stock or securities." *Id.* at 462 (emphasis added). The court expressly reaffirmed the standard in *Texas Gulf Sulphur*, 401 F.2d at 849. Subsequently, in *SEC v. Great American Indus., Inc.*, 407 F.2d 453 (2d Cir. 1968), cert. denied, 395 U.S. 920 (1969), Judge Friendly noted: "This court has defined a material fact as a fact to which 'a reasonable man would attach importance . . . in determining his choice of action in the transaction in question.' . . . We have further developed our views on materiality in *SEC v. Texas Gulf Sulphur Co.* . . ." *Id.* at 459-60.

Both tests have been adopted by other courts. *Myzel v. Fields*, 386 F.2d 718, 734 n.7 (8th Cir. 1967), cert. denied, 390 U.S. 951; *Rogen v. Ilkon Corp.*, 361 F.2d 260, 266 (1st Cir. 1966); *Kohler v. Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963); accord, *SEC v. R. A. Holman & Co.*, 366 F.2d 456, 458-59 (2d Cir. 1966), rehearing denied per curiam, 377 F.2d 665 (2d Cir. 1967), cert. denied, 389 U.S. 991; *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir. 1965), cert. denied sub nom., *List v. Lerner*, 382 U.S. 811.

⁶⁸ 401 F.2d at 851.

⁶⁹ *Id.* at 850.

⁷⁰ The phrase was used by Commissioner Smith to describe, with approval, the SEC's test. *Investors Management Co.*, [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 at 80,523.

⁷¹ *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,629 at 83,350.

⁷² It would not appear that any significance should be attached to the SEC's failure

exist *likelihood* of a "material" effect on the market price of a company's securities before a violation of Rule 10b-5 can occur;⁷³ but the Second Circuit would appear to require only the *possibility* of an effect on market price.⁷⁴ The differing standards may produce different

to refer to a "reasonable" investor. In *Texas Gulf Sulphur* the district court had declared that "the test of materiality must necessarily be a conservative one" and excluded speculators from the class of "reasonable men." SEC v. Texas Gulf Sulphur Co., 258 F. Supp. 262, 280 (S.D.N.Y. 1966). The court of appeals reversed, admonishing the lower court by stating that "[t]he speculators and chartists of Wall and Bay Streets are also 'reasonable' investors entitled to the same legal protection afforded conservative traders." 401 F.2d at 849.

⁷³ For a number of years prior to the *Merrill Lynch* opinion, the members of the Commission and its staff consistently had described the materiality element in terms similar to those used by the Commission in *Merrill Lynch*. See address by former Commissioner Hamer H. Budge of the SEC before the New York Chapter of the American Society of Corporate Secretaries, in New York, Nov. 18, 1965 ("significant information"); Ferber, Disclosure of Corporate Information, 22 Financial Analysts J. 19, 20 (July-Aug. 1966) (facts which "might reasonably be expected to have a substantial effect on the price of the company's securities"); comments of David Ferber, Solicitor, Office of General Counsel, SEC, in Texas Gulf Sulphur—Insider Disclosure Problems 314 (A. Fleischer & J. Flom, Co-Chairmen, PLI 1968) (information "which has an immediate and substantial effect on the price of the stock").

Shortly after the *Merrill Lynch* settlement, the SEC released an opinion containing a reference to the Texas Gulf Sulphur definition which could have implied unreserved affirmation of the Second Circuit's test. Blyth & Company, [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,647 at 83,397 n.1a. Only two weeks later, however, the *Merrill Lynch* formulation was expressly reaffirmed in Van Alstyne, Noel & Co., [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,656 (1969). See also Address by Former Chairman Manuel F. Cohen of the SEC before the Baltimore Securities Analysts Society, in Baltimore, Md., Jan. 6, 1969.

⁷⁴ The SEC has indicated its belief that the market-impact phrasing of the standard by the court of appeals is in reality the same test as the one the Commission adopted in *Merrill Lynch and Investors Management*. In its brief in opposition to a petition for a writ of certiorari filed by one of the *Texas Gulf Sulphur* defendants, the SEC stated:

Petitioner argues that the court of appeals correctly stated that a *substantial* prospective market impact is necessary to render inside information material and then departed from this standard by dispensing with the requirement of substantiality (Pet. 17-18). We, however, read the phrase "in reasonable and objective contemplation" as designed to exclude matters which might cause insubstantial market fluctuations.

Respondents Brief in Opposition to Certiorari at 13 n.8, *Kline v SEC*, 394 U.S. 976 (1969) (emphasis in original).

The court of appeals in *Texas Gulf Sulphur* did cite with approval a statement of materiality by a former SEC staff attorney similar to the one expressed by the SEC: An insider's duty to disclose information or his duty to abstain from dealing in his company's securities arises only in "those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if [the extraordinary situation is] disclosed" [citation omitted].

401 F.2d at 848. It is doubtful, however, whether the court intended thereby to adopt a market-impact test which requires a "material" effect on the market price of a stock. For in the same part of the opinion, the court repeated its phraseology that the term, "encompasses any fact . . . which in reasonable and objective contemplation *might* affect the value of the corporation's stock . . ." *Id.* at 849 (emphasis added by the court).

results with respect to a broad range of corporate activity. Some developments might not be considered material by the SEC but they could be so considered by a court following *Texas Gulf Sulphur*. For example, it is probable that news of slightly higher earnings, or of an interesting new product with only conjectural possibilities or of a continued gradual decline in profit margins would not be considered material under the SEC standard, since such information is not likely to "materially affect the market price of stock."⁷⁵ But it is quite possible that a court applying the *Texas Gulf Sulphur* standard would find such information material, because the information could be found to be the type as to which "a reasonable man would attach importance . . . in determining his choice of action"⁷⁶ Unfortunately, the confusion resulting from the differences between the two tests may very well end up being resolved by the courts, at the expense of investors who acted in reliance on the SEC's standard, but who nevertheless are found by the court to have violated the Rule.

Regardless which test is used, there is general agreement that certain types of corporate information generally should be considered material.⁷⁷ These would include news of a sizeable reduction or increase in dividends,⁷⁸ a sharp increase or decline in earnings,⁷⁹ an increase or

⁷⁵ See Fleischer, Corporate Disclosure/Insider Trading, 45 Harv. Bus. Rev. 129, 130 (Jan. 1967).

⁷⁶ See 401 F.2d at 849 quoting Restatement of Torts, § 538(2)(a) at 86 (1938).

⁷⁷ The American Stock Exchange has supplied companies with the following list of situations that generally require prompt disclosure and that could be considered as material by the SEC or by a court:

- (a) a joint venture, merger or acquisition;
- (b) the declaration or omission of dividends or the determination of earnings;
- (c) a stock split or stock dividend;
- (d) the acquisition or loss of a significant contract;
- (e) a significant new product or discovery;
- (f) a change in control or a significant change in management;
- (g) a call of securities for redemption;
- (h) the borrowing of a significant amount of funds;
- (i) the public or private sale of a significant amount of additional securities;
- (j) significant litigation;
- (k) the purchase or sale of a significant asset;
- (l) a significant change in capital investment plans;
- (m) a significant labor dispute or disputes with subcontractors or suppliers;
- (n) an event requiring the filing of a current report under the Securities Exchange Act;
- (o) establishment of a program to make purchases of the company's own shares; and
- (p) a tender offer for another company's securities.

American Stock Exchange Company Guide, pt. 4, at 103-04 (April 15, 1968).

⁷⁸ Cady, Roberts & Co., 40 S.E.C. 907 (1961) (reduction of dividend from \$.625 per share to \$.375 per share was material); Cochran v. Channing Corp., 211 F. Supp. 239 (S.D.N.Y. 1962) (reduction of dividend caused by controlling person in order to facilitate purchase program).

⁷⁹ Investors Management Co., [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep.

decrease in sales,⁸⁰ the progress of a significant mineral exploration program,⁸¹ and major financing problems.⁸² The information does not have to involve current developments; it can also involve impending corporate developments such as a proposed stock offering by a closely held company,⁸³ the planned liquidation of a subsidiary at a dramatic profit, or the sale of a corporation's assets.⁸⁴ Projections of sales, earnings, cash flow and acquisitions can also be covered by the Rule,⁸⁵ as well as news that previously reported projections were significantly inaccurate.⁸⁶

Normally, such information would probably not be disclosed to an analyst or researcher.⁸⁷ Most likely, interviews are limited to such mat-

¶ 77,832 (decline in earnings from 85 cents for five-month period to 12 cents for six months); *Mates Financial Services*, [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,790 (quarterly increase from \$.03 loss to \$.15 earnings); *Van Alstyne, Noel & Co.*, [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,656 (pre-tax earnings for nine-month period almost five times greater than prior year).

⁸⁰ *Van Alstyne, Noel & Co.*, id. (sales of over \$2 million for two-month period versus \$3 million for entire prior year); *Black v. Shearson, Hammill & Co.*, 72 Cal. Rptr. 157 (Ct. App. 1968) (actual sales of \$15,000 versus original projection of \$573,100).

⁸¹ 401 F.2d at 833.

⁸² *Black v. Shearson, Hammill & Co.*, 72 Cal. Rptr. 157 (Ct. App. 1968) ("required extensive financing . . . was not obtainable").

⁸³ *Ross v. Licht*, 263 F. Supp. 395 (S.D.N.Y. 1967) (proposed private offering at \$300 per share and public offering at \$600 per share at the time of purchase at \$120 per share).

⁸⁴ *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951), supp. opinion, 100 F. Supp. 461, petition for order to reopen case denied, 100 F. Supp. 463 (sale of subsidiary to obtain undisclosed inventory profit); *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947) (agreement to sell entire assets made 8 hours before delivery of plaintiff's stock).

⁸⁵ SEC v. *Glen Alden Corp.*, [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,280 (1968); *Van Alstyne, Noel & Co.*, [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,656.

⁸⁶ See *Black v. Shearson, Hammill & Co.*, 72 Cal. Rptr. 157 (Ct. App. 1968).

⁸⁷ The New York Stock Exchange Company Manual provides:

A company should not give information to one inquirer which it would not give to another. Nor should it reveal information it would not willingly give to the press for publication. Thus, for corporations to give advance earnings, dividend, stock split, merger, or tender information to analysts, whether representing an institution, brokerage house, investment advisor, large stockholder, or anyone else, would be clearly incompatible with Exchange policy. On the other hand, it should not withhold information in which analysts or other members of the investing public have a warrantable interest.

NYSE Company Manual, § A2, at A-20 (1968).

Recent statements by the Chairman of the SEC have implied that companies may have some duty to undertake the impossible task of policing what analysts say about them. In one speech the Chairman stated that "if a company knows that an analyst has made an accurate projection on what a new product or some new development will do to a company's earnings per share and that his projection will be given to investors, this combination of events creates an obligation for the company to make some kind of announcement." The Public Interest in Our Securities Markets, Address by Chairman William J. Casey of the SEC before the Institutional Trading Conference, in New York City, June 17, 1971, SEC News Release (June 17, 1971) at 10-11.

ters as general management and labor relations, the development of new products, planned inventory levels, information on performance and prospects for various products or product groups, clarification of financial statements and projected capital or research and development expenditures.⁸⁸ Absent an extraordinary occurrence, *individual* pieces of information of this type are not considered material because they would likely not have a direct effect on a reasonable investor's judgment or the market price of a company's stock. But if the pieces of information obtained by an analyst were aggregated, the sum could very well be a principal factor⁸⁹ in his investment decision. The question therefore arises whether extensive collections of various items of nonpublic, nonmaterial information should be held to violate either the SEC's or the Second Circuit's standard of materiality.

It is submitted, however, that a test which takes into account the *cumulative* effect of nonmaterial information would eliminate materiality as an element, and would impose an unreasonable burden on investment companies. Such a test would probably prove to be impossible of application in practice. Furthermore, it is doubtful whether such a rule would serve to place investors on a more equal footing, although it certainly would deter analysts and researchers from digging behind or seeking clarification of published corporate reports.⁹⁰ The Second Circuit in *Texas Gulf Sulphur* sought to dispel any question that its standard of materiality encompasses the type of knowledge which corporate insiders usually possess in connection with the management of a company. For the sake of consistency, it would seem only logical that the elements of responsibility for analysts who obtain nonpublic information from an insider should be no different from those applied to the insider himself.

As in the case of corporate insiders, analysts may be guided in their investment decisions by more than "superior financial or other

The Chairman of the SEC also stated that he believes management may have an obligation to make a public announcement whenever it confirms or corrects a projection by analysts. *Id.* See also *Responsibilities and Liabilities in Corporate Life*, Address by Chairman William J. Casey of the SEC before the Conference Board, in New York City, Nov. 18, 1971, SEC News Release (November 18, 1971). Presumably the obligation arises only if the projections involve material information.

⁸⁸ See Bjork, *The Views of the Analysts*, in *Texas Gulf Sulphur: Disclosure and Insiders* 187 (A. Fleischer & J. Flom, Co-chairmen, PLI 1968).

⁸⁹ The SEC has stated that the material information need only be "a factor" in a tippee's decision to trade. [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 at 80,522.

⁹⁰ If the subject matter of an interview consists only of generally known facts, it is beyond question that no responsibility exists under Rule 10b-5. To paraphrase Professor Loss' statement on insiders, an analyst or other investor is under no obligation to give the public the benefit of his superior financial analysis. See 3 L. Loss, *Securities Regulation*, 1463 (2d ed. 1961).

expert analysis,"⁹¹ and they may possess specialized knowledge about the company, or at least about some aspects of its operations, or what its future prospects might be. Despite whatever advantage this knowledge may provide them over other investors, there is no justification for applying a stricter test to analysts than is applied to insiders, for the analyst will never be in any better investment position by virtue of the knowledge than the insider. Evidently the SEC has adopted the view that the standards for tippees should be the same as those for insiders. In reaffirming the standard of materiality used in its Merrill Lynch opinion, the SEC expressly declared in *Investors Management* that "even if respondents are viewed as indirect recipients [tippees] of the Douglas information, the same criteria for finding a violation of the anti-fraud provisions by the respondents properly apply."⁹²

Although the apparent difference between the standards of materiality adopted by the SEC and Court of Appeals for the Second Circuit may at times produce different results, both the court and the SEC appear to agree on one important point: in the determination of whether facts are material, a major factor is the "importance attached" to the facts by those who know them.⁹³ Evidence of trading activity by the persons who obtain the information is "highly pertinent . . . and the only true objective evidence of materiality"⁹⁴ Because the question whether the facts of a particular case are material will likely be answered through hindsight, it is evident that any investment company caught trading in securities shortly after obtaining nonpublic information will have little chance of avoiding liability under section 10(b) and Rule 10b-5.

B. Nonpublic Information

A difficult issue faced by the Hearing Examiner and the SEC in the *Investors Management* proceeding was whether the information received from Merrill Lynch on the decline in Douglas' earnings had become public. Some respondents testified that rumors of Douglas' poor earnings results were circulating in the financial community on June 21, 1966, the same day that the news was given to Merrill Lynch's New York Institutional Sales Office, and that on June 22 the

⁹¹ 401 F.2d at 849.

⁹² [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 at 80,521. There is no suggestion in the Hearing Examiner's opinion, either, that a stricter test than materiality should be applied to tippees. *Investors Management Co., Inc.*, [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,832, at 83,940-941. Nor did the SEC staff argue under any test other than the one applied to Merrill Lynch in their brief in *Investors Management*. Brief for the SEC's Division of Trading and Markets Investors Management Co., Admin. Proceedings File No. 3-1680 (Oct. 9, 1969).

⁹³ 401 F.2d at 851.

⁹⁴ *Id.*

rumors were widely known among a group of about fifty institutional investors attending a luncheon.⁹⁵ The SEC rejected the argument that the circulation of the rumor was sufficient evidence that the news had become publicly available. It found that the high quality of the Merrill Lynch information—the specific figures of actual and projected earnings and the attribution of the source to an access insider—in contrast to the low quality of the rumors, served to establish that the information they received was nonpublic.⁹⁶ Moreover, the SEC declared that even if the persons attending the luncheon had had the very same information as that received from Merrill Lynch, that group would be too limited in size “to constitute the kind of public disclosure that would suffice to place other investors in an equal position in the market place.”⁹⁷ The test to be applied, according to the SEC, is whether the information has “been disseminated in a manner making it available to investors generally.”⁹⁸

The SEC standard appears to be compatible with that adopted by the Second Circuit. In *Texas Gulf Sulphur*, Judge Waterman stated that, “[b]efore insiders may act upon material information, such information must have been *effectively* disclosed in a manner sufficient to insure its availability to the *investing public*.”⁹⁹ In the case of one defendant, there was unanimous agreement that he had violated Rule 10b-5 by placing his order¹⁰⁰ immediately after Texas Gulf made its announcement,¹⁰¹ because, “[a]ssuming that the contents of the offi-

⁹⁵ [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 at 80,519-520.

⁹⁶ *Id.* at 80,520.

⁹⁷ *Id.* Similarly, information disclosed at a financial analysts' meeting would not be considered publicly available for Rule 10b-5 purposes. See Responsibilities and Liabilities in Corporate Life, Address by William J. Casey, Chairman of the SEC, before Conference Board, New York City, Nov. 18, 1971, SEC News Release (Nov. 18, 1971).

⁹⁸ [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 at 80,520.

⁹⁹ 401 F.2d at 854 (emphasis added).

¹⁰⁰ It was held in *Texas Gulf Sulphur*, apparently unanimously, that “[t]he effective protection of the public from insider exploitation of advance notice of material information requires that the time that an insider places an order, rather than the time of its ultimate execution, be determinative for Rule 10b-5 purposes.” *Id.* at 853 n.17. The statement of the two dissenting judges with regard to Coates that “for all practical purposes the information had not become public at the time of his purchase order” indicates their agreement with this conclusion. *Id.* at 888.

¹⁰¹ The lower court absolved one defendant who had placed his telephone order immediately after the April 16th announcement was released to the financial press. 258 F. Supp. at 288. The Second Circuit stated that in so doing, the lower court had “misinterpreted” the following dictum in *Cady, Roberts*:

[that insiders are to] “keep out of the market until the established procedures for public release of the information are *carried out* instead of hastening to execute transactions in advance of, and in frustration of, the objectives of the release,” 40 SEC at 915 (emphasis supplied).

401 F.2d at 854.

The sequence of events was as follows: the announcement was made in the United States at 10:00 a.m. on April 16; the Dow Jones reporter left the press conference with

cial release could be *instantaneously* acted upon, at the minimum . . . [he] should have waited until the news could reasonably have been expected to appear over the media of widest circulation, the Dow Jones broad tape. . . ."¹⁰² The court's prefatory remark suggests that insiders and tippees must wait until the news has been carried by the financial services and is in the hands of investors.¹⁰³ The SEC has properly defined the element of timing in terms of when there has occurred adequate dissemination of the information by the new services.¹⁰⁴ It is not clear whether the SEC's use of the term "disseminated" in *Investors Management* involves anything different than that required by the Second Circuit's phrase "effectively disclosed" in *Texas Gulf Sulphur*.

As a practical matter, it can never be precisely ascertained when investors have finished their evaluation and when the market price of the stock reflects the new information. Although it is arguable that the persons having inside information are in the best position to judge when the time has occurred, this approach would nevertheless unreasonably subject them to liability through hindsight. Often a small company is unable to get news services to carry news the company believes is important; and alternative modes of dissemination prove to be costly and less efficient means of communication.¹⁰⁵ Some-

the release at approximately 10:10; Coates placed his telephone order shortly before 10:20; the news appeared on the Dow Jones broad tape at 10:54 and the Merrill Lynch private wire at 10:29. *Id.* The court disregarded as ineffective an abbreviated version of the press release which was given to the Canadian press at 9:40 a.m. *Id.* at 853-54.

¹⁰² 401 F.2d at 854 n.18.

¹⁰³ In a note to this part of the majority opinion, Judge Waterman commented:

Although the only insider who acted after the news appeared over the Dow Jones broad tape is not an appellant and therefore we need not discuss the necessity of considering the advisability of a "reasonable waiting period" during which outsiders may absorb and evaluate disclosures, we note in passing that, where the news is of a sort which is not readily translatable into investment action, insiders may not take advantage of their advance opportunity to evaluate the information by acting immediately upon dissemination. In any event, the permissible timing of insider transactions after disclosures of various sorts is one of the many areas of expertise for appropriate exercise of the SEC's rule-making power, which we hope will be utilized in the future to provide some predictability of certainty for the business community.

Id. Immediately after the *Texas Gulf Sulphur* opinion it was reported that the SEC was considering the possibility of adopting a rule dealing with the question of what is a "reasonable holding period." Green, SEC Considers Telling Insiders How Long to Wait Before Trading on Company News, *Wall Street Journal*, Aug. 30, 1968, at 3, col. 2.

¹⁰⁴ Both the New York and American Stock Exchanges have prepared detailed procedures for public release of information. NYSE Company Manual, § A-2, A-22-4 (1968); American Stock Exchange Company Guide, pt. 4 at 106-08 (Apr. 15, 1968).

¹⁰⁵ If the financial services fail to report a company's announcement, or report it inaccurately and fail to clarify the inaccuracy, it might become necessary for the company to transmit the information to its shareholders in some other manner, such as a report or letter, before orders can be placed. The SEC staff has taken the position that teletyping press releases directly to broker-dealers for small companies which have diffi-

times initial investor reaction is opposite to what was expected, and it becomes unclear whether a contrary market reaction will then follow.¹⁰⁶ At other times the price of a stock will continue to rise, or fall, for some time after an announcement. For example, in the case of an important acquisition the market price of the stock of the acquired company may continue to rise steadily after the initial announcement, as investor confidence in the likelihood of the event taking place becomes stronger.

Because it is difficult under both the court and SEC tests to determine when an insider or tippee is no longer obligated to remain silent and inert, there will always be a period of uncertainty following publication of news over wire services as to whether sufficient dissemination has occurred. This specific issue was raised in *Texas Gulf Sulphur* by three defendants who argued that they honestly believed that the news of the mineral discovery had become public by the time they placed their orders. The majority opinion rejected their defense of "good faith" for the reason that proof of specific intent to defraud is unnecessary in an enforcement proceeding, and that in such a case negligence will support a violation of Rule 10b-5.¹⁰⁷ In the court's view, the defendants' beliefs were not reasonable in view of the fact that their orders had obviously been placed before the news of the announcement was adequately disseminated.¹⁰⁸

The analysis of the Second Circuit in this respect is similar to that in its discussion of materiality.¹⁰⁹ The result obtained is that an

culty getting news media to carry their announcements would not constitute public disclosure. Letter from SEC Office of Chief Counsel to Boss & Company Inc., March 13, 1972, [Current] CCH Fed. Sec. L. Rep. ¶ 78,663.

¹⁰⁶ See, e.g., the situation described in University of Pennsylvania Law School Conference on Mutual Funds, Mutual Funds as Investors of Large Pools of Money, 115 U. Pa. L. Rev. 669, 721 (1967).

¹⁰⁷ 401 F.2d at 854-56. Although the court's holding was limited to the proposition that negligence will support a cause of action under Rule 10b-5 in an injunctive proceeding by the SEC, other courts have held that negligence is also sufficient in a private action for damages. *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), cert. denied, 390 U.S. 951; *City National Bank v. Vanderbloom*, 422 F.2d 221 (8th Cir. 1970); *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961). In a footnote to the *City National Bank* decision, the Eighth Circuit suggested, despite Judge Friendly's strong statement otherwise in a concurring opinion, that language in *Texas Gulf Sulphur* "permits the inference that the Second Circuit may be on the verge of dropping the scienter requirement in private actions." 422 F.2d at 230 n.9. While some uncertainty still exists in the Second Circuit, other circuit courts have required fraud as an element of a cause of action under section 10b and Rule 10b-5. *Kohn v. American Metal Climax, Inc.*, [Current] CCH Fed. Sec. L. Rep. ¶93,428 (3d Cir. March 31, 1972); *Herpich v. Wallace*, 430 F.2d 792 (5th Cir. 1970).

¹⁰⁸ The court stated that "a mistaken belief as to the applicable law . . . does not insulate . . . [insiders] from the consequences of their acts . . ." although presumably a mistake of fact would be a defense. 401 F.2d at 852 n.15. The four separately concurring judges agreed, with Judge Friendly stating that "[w]hile . . . an erroneous view of the law is pardonable, it is not 'good faith' in the legal sense." Id. at 868 n.4.

¹⁰⁹ See text accompanying notes 93 and 94 supra.

investment company which acts on material information immediately after it is made public, but before it is digested by investors, incurs substantial exposure to liability for a violation of section 10(b) and Rule 10b-5. Although the SEC standard provides relatively greater certainty in a number of situations, both tests make it unwise for an investment company to attempt to gain any advantage over other investors from material, nonpublic information in the period immediately following public announcement of the information. Indeed, any trading in the stock concerned, even if scheduled for reasons unrelated to the inside information, will risk misinterpretation by a court. The investment company is not unduly penalized by this situation, which *assumes* that it already had material information in its possession. The average investor just receiving that information deserves some "response time" before he is at a par with the professional investor.

C. *Requisite Knowledge*

Since their business is investing and reinvesting in securities, investment companies are always in the market for information. An investment company may be subject to the requirements of Rule 10b-5 if it obtains material, nonpublic information (1) in connection with a purchase of restricted securities from an issuer under the private offering exemption of the Securities Act of 1933;¹¹⁰ (2) from one of its affiliated persons who is a corporate insider of the issuer;¹¹¹ or (3) from a company's investment banking firm.¹¹² Similarly, a duty under

¹¹⁰ In such a case the investment company itself will acquire a "special relationship" with respect to the issues and thereby become an access insider. Cf. *Cady, Roberts & Co.*, 40 S.E.C. at 912. See text accompanying notes 15-19 *supra*.

¹¹¹ Section 2(a)(3) of the 1940 Act, 15 U.S.C. § 80a-2(a)(3) (1970), defines affiliated person to mean:

(A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

¹¹² *Investors Management Co.* [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 at 80,519; *Investors Management Co.* [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,832 at 83,939-40. The respondents in the *Merrill Lynch* proceeding argued that, if they were tippees, they were only "remote tippees," as distinguished from the partner-tippee of *Cady, Roberts*. The SEC rejected this as a rationale for distinguishing their case:

Although the case of such an indirect recipient may present more questions of factual proof of the requisite knowledge, the need for the protections of those provisions in the tippee area is unaffected.

Rule 10b-5 should arise if (4) a financial analyst for an investment company or its investment adviser *directly* obtains material, nonpublic information in an interview with a corporate official and passes it on to the investment company.¹¹³

In the first two cases there is little question that the investment company would be considered an insider under the standards established in *Cady, Roberts* and affirmed by the Second Circuit in *Texas Gulf Sulphur*, for in each case it is evident that the investment company has acquired a significant investment advantage as the result of a special relationship it has, directly or indirectly, with respect to the issuer. In the other two cases, the investment company would be considered subject to Rule 10b-5 under the rationale of *Investors Management*. But there remains the question of whether an investment company may become subject to Rule 10b-5's proscriptions in other situations, such as when the information originates from a corporate source but reaches the company through several intermediaries, or when the information is provided by someone with no special relationship or access to the issuer.

Although the prohibitions of section 10(b) and Rule 10b-5 apply to "any person,"¹¹⁴ it has never been suggested that the duty to disclose material, nonpublic information or refrain from trading in the securities of the company to which it relates applies without limit to all investors. In its decision in *Cady, Roberts* the SEC described the element limiting the scope of the Rule as "the existence of a relationship giving access directly or indirectly, to information intended to be available only for a corporate purpose and not for the benefit of anyone"¹¹⁵ The SEC held that in addition to persons such as officers, directors and employees, all of whom are privy to confidential corporate information by virtue of their direct relationship with a corporation, the Rule also covers persons who might be characterized as "access" insiders because of some direct or indirect "special relationship" to the corporation. The partner in *Cady, Roberts* was held to be such a person by virtue of his own relationship to a director of Curtiss-Wright.¹¹⁶

Investors Management Co. [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 at 80,521.

¹¹³ See *Ross v. Licht*, 263 F. Supp. 395, 410 (S.D.N.Y. 1967); cf. also *The Public Interest in Our Securities Markets*, Address by William J. Casey, Chairman of the SEC, before the Institutional Trading Conference, in New York City, June 17, 1971, SEC News Release (June 17, 1971); *Responsibilities and Liabilities in Corporate Life*, Address by William J. Casey, Chairman of the SEC, before the Conference Board, in New York City, November 28, 1971, SEC News Release (Nov. 28, 1971).

¹¹⁴ See notes 36-37 *supra*.

¹¹⁵ 40 S.E.C. at 912.

¹¹⁶ See text accompanying notes 35-41, *supra*.

INVESTMENT COMPANIES AND INSIDE INFORMATION

The Second Circuit in *Texas Gulf Sulphur* affirmed the principles established by the SEC in *Cady, Roberts*. The judges unanimously agreed that the concept of an insider is not limited to officers, directors and major stockholders of issuers who are subject to Section 16(b) of the 1934 Act.¹¹⁷ The majority evidently adopted the view that the coverage of Rule 10b-5 extends to any person who possesses material, nonpublic information acquired as a result of some direct or indirect special relationship which gives that person access to a corporate source not enjoyed by other investors.¹¹⁸

In its *Investors Management* opinion, the SEC provides a test which extends the duty to disclose, or refrain from dealing, beyond the limits indicated in *Cady, Roberts*: "the tippee, whether he receives the information directly or indirectly, [must] know or have reason to know that it was obtained improperly by selective revelation or otherwise"¹¹⁹ The SEC noted that it specifically intends to impose responsibility regardless of whether the material, nonpublic information originated with a corporate insider or an access insider, such as a prospective underwriter.¹²⁰ Such a formulation substitutes mere "reason to

¹¹⁷ 15 U.S.C. § 78p(b) (1970). See note 41 supra. The majority opinion states that:

Insiders, as directors or management officers are, of course, by this Rule, precluded from so unfairly dealing [with the investing public], but the Rule is also applicable to one possessing the information who may not be strictly termed an "insider" within the meaning of Sec. 16(b) of the Act.

401 F.2d at 848. This is necessarily a unanimous holding since all the judges affirmed the district court's holding that Clayton, who was only an employee, had violated the Rule.

¹¹⁸ The majority opinion indicates that

[t]he essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," i.e., the investing public [citation omitted].

Id. The court of appeals at one point stated that "*anyone* in possession of material inside information" has a duty of disclosure under Rule 10b-5. Id. (emphasis added). Subsequently, however, the court commented that the congressional concern in this area was "unequal access to knowledge," id. at 852 (emphasis added), which indicates affirmation of the *Cady, Roberts* limitations.

¹¹⁹ *Investors Management Co.*, [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 at 80,519. The Commission then explained:

We consider that one who obtains possession of material, non-public corporate information, which he has reason to know emanates from a corporate source, and which by itself places him in a position superior to other investors, thereby acquires a relationship with respect to that information within the purview and restraints of the antifraud provisions.

Id. Commissioner Smith, concurring in the result, disagreed with the Commission's statement as embodying "a concept—too vague for me to apply with any consistency—of relative informational advantages in the marketplace." Id. at 80,523.

¹²⁰ The SEC's explanation of this element of the SEC test is as follows:

Our formulation would clearly attach responsibility in a situation where the

know" that the information originated from a "corporate source" for the "relationship giving access" test which the SEC first adopted. Although the new SEC standard does not impose responsibility on the investor who discovers material nonpublic information "by general observation or analysis,"¹²¹ it could impose responsibility in every other possible situation. Thus, the test indicated in *Investors Management* would greatly enlarge the number of situations in which a person could be held liable.

The SEC's explanation that responsibility may arise "where persons innocently come into possession"¹²² of material, nonpublic information confirms that it no longer intends to apply the "special relationship" test of *Cady, Roberts*. Suppose that a financial analyst is indiscreetly given important nonpublic information at a cocktail party by one who has had "one too many" but who has no known connection with the issuer involved. Although there appears to be no justification for imposing a duty of disclosure on the analyst who "innocently came into possession" of the information,¹²³ the SEC might try to do so on the grounds that it gives him an advantage over other investors and that he has "reason to know that it . . . had been obtained by selective revelation or otherwise."¹²⁴

The SEC's formulation could also be interpreted as implying that the inside information need not originate with the corporation whose securities are involved. If, as the opinion states at one point, the "relationship" element of *Cady, Roberts* is actually one which refers to the superior investment position obtained by a person having material, nonpublic information, it could follow that the duty to disclose arises regardless of the source.¹²⁵ If this is the case, it is possible that an in-

recipient knew or had reason to know the information was obtained by industrial espionage, commercial bribery or the like. We also consider that there would be potential responsibility, depending on an evaluation of the specific facts and circumstances, where persons innocently come into possession of and then use information which they have reason to know is intended to be confidential.

Id. at 80,519 n.18.

¹²¹ Id.

¹²² Id.

¹²³ It does not appear that the court of appeals in *Texas Gulf Sulphur* intended to limit the basis of the duty to disclose under Rule 10b-5 to situations involving a fiduciary duty. A broader basis is suggested by the court's comments that the 1934 Act was designed "to insure fairness in securities transactions generally," 401 F.2d at 848, and that "[t]he core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions . . . [and] be subject to identical market risks. . . ." Id. at 851-52. Nevertheless, there is no indication that the court intends to define the class of persons subject to the duty to disclose under Rule 10b-5 in a manner broader than that established in *Cady, Roberts*. See text accompanying notes 117-18 *supra*.

¹²⁴ *Investors Management Co.*, [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 at 80,519 (emphasis added).

¹²⁵ Some slight indication that the SEC may have reserved the right to act in this

vestor could become subject to a duty to disclose material, nonpublic information, such as the impending award of a major contract or commencement of an important lawsuit or administrative proceeding, which originates outside of and is unknown to the company whose securities are being traded. Such an interpretation, however, would be inconsistent with the principle followed by courts in tender offer situations that a company and its "friends" secretly acquiring shares prior to a takeover attempt have no duty to disclose their identity or intentions.¹²⁶

The SEC in *Investors Management* evidently has taken a first step toward the establishment of a broad class of persons subject to the duty of disclosure under section 10(b) and Rule 10b-5—a class which could encompass significantly more investors than are now covered under the standard adopted in *Cady, Roberts* and affirmed in *Texas Gulf Sulphur*. With respect to the outer limits, the SEC has stated only that which was never in doubt: that a person is under no duty to disclose information "which is obtained by general observation or analysis."¹²⁷ But it is unclear whether an investor having no special relationship or access to a company will be subject to a duty of disclosure if he obtains material, nonpublic information not knowing how it got out of the company, or if he obtains information which is unknown even to the issuer itself. By using broad language and adopting vague concepts to describe when a person may become subject to Rule 10b-5, the SEC has contributed to, rather than reduced, the confusion over who can be held liable as a tippee.

D. A Factor in Investment Decision

The duty imposed by section 10(b) and Rule 10b-5 requires that tippees and insiders disclose material, nonpublic information to others

direction might be found in the SEC's use of the article "a" at one point in its opinion. The SEC stated that the person in possession of information must have "reason to know [that it] emanates from a corporate source . . ." Id. at 80,520.

¹²⁶ Investment companies have been involved in corporate takeovers in a number of cases where no attempt was made to impose responsibility under Rule 10b-5 for their purchases of securities of the target company. *Bath Industries, Inc. v. Blot*, 305 F. Supp. 526 (D. Wis. 1969), aff'd and remanded 427 F.2d 97 (7th Cir. 1970); *Bangor Punta Corp. v. Chris-Craft Indus. Inc.*, [Current] CCH Fed. Sec. L. Rep. ¶ 93,294 (S.D.N.Y. 1971).

In a brief filed by the SEC in the case of *Pacific Insurance Company v. Blot* . . . the SEC took the position that a party acquiring shares in the open market prior to a planned tender offer need not inform purchasers of the prospective offer.

Fleischer & Mundheim, *Corporate Acquisitions by Tender Offer* (rev. ed. April, 1968) reprinted in A.B.A. Section of Corporation, Banking and Business Law, *Selected Articles on Federal Securities Law* at 830 n.60. For a discussion of the takeover problem see, *Comment, Participation by Mutual Funds in Corporate Takeovers*, infra at 1113.

¹²⁷ *Investors Management Co.* [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 at 80,519 n.18.

or that they not use it themselves.¹²⁸ If no causal connection exists between the information and the investment decision, however, an investor will not be held liable for transactions made prior to public dissemination of the information.¹²⁹ On this point, the Hearing Examiner in *Investors Management*, after rejecting the contentions of a number of other respondents that their sales were motivated by factors other than the Merrill Lynch information, found that one adviser to a large registered investment company had not committed a violation of Rule 10b-5 because "no use was made of the information."¹³⁰ The Examiner based his conclusion on a factual finding that the financial analyst employed by the adviser refused to disclose to his superiors the real reason for his adamant sell recommendations.¹³¹ Although the majority of the Commissioners accepted the Hearing Examiner's findings and conclusions, they were obviously disturbed by them.

The Commissioners noted:

[I]n future cases we would view as suspect and subject to close scrutiny a defense that there was no internal communication of material non-public information and its source by a member of a broker-dealer firm or other investment organization who received it, where a transaction of the kind indicated by it was effected by his organization immediately or closely thereafter. A showing of such receipt and transaction prior to the time the information became public should in itself constitute strong evidence of knowledge by the one who effected the transaction and by the firm.¹³²

The majority stated that a sufficient causal connection will be found whenever the material, nonpublic information is "a factor in the investment decision"¹³³ The SEC, warning that its test of causation is intended to be a broad one, declared that whenever someone who possesses material, nonpublic information about a company engages in advantageous trades in the securities of that company a

¹²⁸ Id. at 80,521; see also 401 F.2d at 848.

¹²⁹ *Investors Management Co.*, [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,832 at 83,971.

¹³⁰ *Investors Management Co.*, [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,832 at 83,961.

¹³¹ Id. at 83,959-61. The testimony showed that the analyst not only had insisted that the holding be sold, he had even threatened to resign if his advice was not followed. Nevertheless, the Hearing Examiner held that no material, nonpublic information had been used because the person making the investment decision did not know of the existence of the information in the adviser's organization.

¹³² *Investors Management Co.* [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 at 80,522 n.28.

¹³³ *Investors Management Co.* [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 at 80,522.

presumption will arise that such information was a factor in his investment decision.¹³⁴ As a result, it is unlikely that in the future any tippee or insider having inside information who engages in a securities transaction prior to public announcement will be able to avoid liability by denying that the information influenced his decision.

One Commissioner disagreed with the majority's concept of causal connection. He noted that "[t]he Commission's staff in this case, and in *Cady, Roberts* and *Texas Gulf*, accepted the burden of proving that the inside information was *the motivating* factor, and not just a factor, in the decision to effect the transaction."¹³⁵ The Commissioner, determining that the standard used by the SEC's own staff and adopted by the Hearing Examiner in his initial decision was not unduly burdensome, disapproved the adoption of a broader one.

It seems clear that the Hearing Examiner and the Commissioner properly required that material, nonpublic information be communicated in some manner to the individual responsible for making investment decisions in order for a violation of section 10(b) and Rule 10b-5 to occur. It would be unreasonable to penalize an institution effecting securities transactions in situations where an employee had possession of information about the issuer but never disclosed it to anyone, either directly or indirectly. Such a result would be inconsistent with the obligation imposed under Rule 10b-5 not to pass on any material, nonpublic information absent a legitimate corporate purpose.¹³⁶

It is doubtful, however, whether this requirement will have any significant value for investment companies in actual situations, for it is unlikely that an analyst assigned to a particular company can remain silent when an investment decision is about to be made with respect to that company's securities. Moreover, if the analyst having inside information prepares a report on the company but does not indicate in his report that his recommendations were based on anything other than proper information, it still would appear that a violation could be found. Unless the individual responsible for making the investment decision can show that the analyst's report was not a factor in his decision, it is unlikely that the SEC or a court would find that the

¹³⁴ The SEC stated that:

[W]e are of the opinion that where a transaction of the kind indicated by the information (e.g., a sale or short sale upon adverse information) is effected by the recipient prior to its public dissemination, and [sic] inference arises that the information was such a factor.

Id.

¹³⁵ Id. at 80,524 (emphasis added).

¹³⁶ Rule 10b-5 was adopted in 1942 without notice and opportunity for hearing. Securities Exchange Act Release No. 323 (May 21, 1942). For a description of its informal origin, see remarks of Milton Freeman, Conference on Codification of the Federal Securities Law, 22 Bus. Lawyer 793, 922 (1967). The Rule has not been revised since its adoption.

information on which the report was written was not indirectly a factor.

CONCLUSION

The development of the law extending the duty of disclosure under section 10(b) and Rule 10b-5 beyond corporate and access insiders is not surprising in view of *Cady, Roberts* and *Texas Gulf Sulphur*. Because the development has been only by interpretation on a case by case basis, however, there are overly broad areas of current law in which conduct intended in good faith to be honest may expose investors and investment companies to substantial liabilities.¹³⁷

The SEC and the Court of Appeals for the Second Circuit appear to differ significantly regarding the elements which form the duty of disclosure under section 10(b) and Rule 10b-5. It is submitted that in trying to adopt a standard which would establish a relatively high level of materiality and provide investors with a relatively high degree of certainty,^{137a} the SEC has disregarded the test established by the court.

¹³⁷ The majority points out in *Texas Gulf Sulphur* that: "Even if insiders were in fact ignorant of the broad scope of the Rule and acted pursuant to a mistaken belief as to the applicable law such an ignorance does not insulate them from the consequences of their acts." *Id.* at 852 n.15. See also *Investors Management Co.*, [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 at 80,522.

^{137a} The Supreme Court, on April 24, 1972, decided an important case under section 10(b) and Rule 10b-5, *Affiliated Ute Citizens of the State of Utah vs. United States*, 40 U.S.L.W. 4448 (Apr. 24, 1972). Although the case did not involve market transactions, the holding of the Court may well apply to transactions in the securities markets as well as to person-to-person transactions. The case involved a statute which provided for the distribution of valuable assets located on the Ute Indian Tribe's Utah reservation between mixed-blood and full-blood members of the Tribe. As part of the plan, federal supervision over the Tribe's property was terminated, and a development program to assist full-blood members of the Tribe was established. In addition, the mixed-bloods were authorized to organize the Affiliated Ute Citizens (AUC) as an incorporated association which, pursuant to the plan, would create Ute Development Corporation (UDC) to co-manage, together with a tribal committee, the Tribe's oil, gas, and mineral rights and unadjudicated or unliquidated claims against the government.

UDC issued ten shares of its stock to each mixed-blood and made an agreement with First Security Bank (of Utah) whereby the bank became UDC's stock transferee and held all stock certificates which had been issued. Under UDC's Articles of Incorporation, a mixed-blood shareholder was required, during the period involved, to give first refusal rights to the Tribe members at a price no higher than that in any offer to nonmembers. The district court found that the bank and two of its employees violated Rule 10b-5 in connection with sales by mixed-bloods of UDC stock to the two employees and other persons who were not members of the Tribe. The district court found, *inter alia*, that they had violated their duty to make a fair disclosure by failing to inform the mixed-bloods that they would personally benefit from the sales, as a result of their own purchases and direct or indirect remuneration received on purchases by others, and that the shares of UDC were selling for a higher price in a non-Indian market which the employees had helped to develop and maintain.

The court of appeals reversed this part of the district court's opinion on the ground that the two employees performed essentially ministerial functions in connection with the

Moreover, the literal language of *Investors Management* suggests that the Commissioners¹⁸⁸ may believe that the class of persons who can become subject to a duty of disclosure under Rule 10b-5 is much broader than the *Texas Gulf Sulphur* decision and its own opinion in *Cady, Roberts* would indicate. The SEC's substitution of knowledge that information is "non-public and had been obtained improperly by selective revelation or otherwise" for the requirement that there be some "special relationship" giving access to inside information could mean that the SEC intends to push the coverage of Rule 10b-5 even beyond the type of tippee involved in the *Investors Management* proceeding.

In view of the uncertain state of the law, the advice given by former Chairman Cohen three months before the *Texas Gulf Sulphur* decision—that any doubt on whether information can be used for personal advantage "should be resolved in favor of the investing public

transfer activities and that such conduct is not sufficient to give rise to a duty of disclosure under Rule 10b-5. 431 F.2d 1337 (10th Cir. 1970). The Supreme Court reversed the court of appeals. While agreeing that "if the two men and the employer bank had functioned merely as a transfer agent, there would have been no duty of disclosure," 40 U.S.L.W. at 4456, the Court found that because "[t]he individual defendants, in a distinctive sense, were market makers, not only for their personal purchases comprising 8⅓% of the sales, but for the other sales their activities produced," they did have a duty to disclose material facts. *Id.* With respect to whether material facts were withheld, the court, citing *Chasins v. Smith, Barney and Co.*, 438 F.2d 1167 (2d Cir. 1970), stated that

[t]he sellers had the right to know that the defendants were in a position to gain financially from their sales and that their shares were selling for a higher price in [the non-Indian] market. . . . Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision.

Id. at 4456.

The Affiliated Ute Citizens case is important in the development of Rule 10b-5 for a number of reasons. Adoption by the Supreme Court of the Second Circuit's standard of materiality presents the SEC with a difficult problem. Although this case can be distinguished from *Investors Management* in that the latter involved transactions over a securities exchange, there is no indication that the holding was intended to be limited to person-to-person transactions. The SEC should now decide whether to modify its position on materiality or permit investors to be misled by its statement that an investor will not incur liability unless he possesses a fact likely to have a substantial effect on the market price of an issuer's stock.

The Supreme Court's decision also can be interpreted as affirming the definition of a more limited class of potential tippees described in *Cady, Roberts* and *Texas Gulf Sulphur*. If the Court believed that "any person" could become subject to a duty to disclose material information, regardless of whether any "special relationship" existed, it likely would not have commented that no duty would have existed had the two men and the bank functioned merely as a transfer agent. The *Affiliated Ute Citizens* case also indicates that the SEC's opinion in *Investors Management* is inconsistent with the holdings of the courts and should be clarified.

¹⁸⁸ Commissioner Smith disagreed with the majority's discussion in this area. *Id.* at 80,523-24. See text accompanying note 102.

and the markets generally"¹³⁹—is equally true today. It is not clear, however, whether investment companies, in view of their obligations to their shareholders, can always afford to take that advice when the alternative is to suffer a loss or forego a gain.¹⁴⁰ Moreover, one cannot expect an investment company and its advisers and analysts to disregard investment opportunities in every case when the question of responsibility is doubtful. Since the success of investment companies primarily results from good investment performance, it is more likely that many will follow a policy of assuming the risk of violations. In such a world the only thing probable is that the securities law lawyers are the only persons who will consistently come out ahead.

¹³⁹ Disclosure: The SEC and the Press, Address by former Chairman of the SEC, Manuel F. Cohen, before the Univ. of Connecticut, G.M. Loeb Awards Luncheon, in New York City, May 21, 1968, at 5.

¹⁴⁰ See *Rosenfeld v. Black*, 445 F.2d 1337, 1342 (2d Cir. 1971); *SEC v. Insurance Securities, Inc.*, 254 F.2d 642, 665 (9th Cir. 1958). Only a little help is provided by the unsupported statement of the SEC that

[t]here 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.

[1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163 at 80,522.