
Minn. L. Rev. Editorial Board
Notes


I. INTRODUCTION

Every intelligent transaction in today's business world involves an analysis of the bargain by each party. As the item bargained over becomes more complex, difficulties in analysis necessarily increase. Assessing the value of part ownership in a billion dollar, multi-product enterprise is indeed arduous. Millions of individual investors as well as thousands of financial institutions assign this task to the professional security analyst. Whether an analyst is employed by a stock brokerage house or investment advisory firm, trust company or bank trust department, mutual fund managing concern or life insurance company, his primary role is the same: to assist the investor in making an investment decision.

This purpose coincides with the broad public policy of maintaining an informed market for all business transactions. This public policy is symbolized in the securities area by two major federal laws—the Securities Act of 1933 and the Securities Exchange Act of 1934. Besides the 25 million direct holders of corporate securities, numerous persons own mutual fund shares, have a beneficial interest in a trust fund or in a pension fund which owns securities, or rely on the fiscal health of a security-holding insurance company to assure performance of an insurance contract. See generally 1967 NEW YORK STOCK EXCHANGE ANNUAL REPORT 2, 18.

2. The Financial Analysts Federation has a membership of almost 12,000 persons, the majority of whom are full-time professional analysts. Most analysts also belong to a local society. The New York Society of Security Analysts, with about 4,000 members, is the largest of the local groups. See The Wall Street Journal, Oct. 9, 1968, at 16, col. 3.

An analyst is either a "security analyst" in the strict sense, or a "market analyst." The former, with which this Note is by its nature concerned, evaluates particular securities while the latter studies stock market action per se. Most security analysts concentrate their research on common stocks. See REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 1, at 332, (1963) [hereinafter cited as SPECIAL STUDY].

3. The general public policy is also illustrated by federal and state laws on truth in advertising, packaging and lending. See, e.g., Fair Packaging and Labeling Act, 15 U.S.C. §§ 1451-61 (1964); S. 823, 91st Cong., 1st Sess. (1969) (a bill to enable consumers to protect themselves against arbitrary, erroneous, and malicious credit information); MINN. STAT. § 325.905 (1967) (duty of county attorney to prosecute for false advertising).

change Act of 1934.\(^5\) Rule 10b-5,\(^6\) promulgated by the Securities and Exchange Commission (SEC) in accordance with section 10b\(^7\) of the 1934 Act, has become a potent weapon to attack injustices in the dissemination and use of securities information.\(^8\) One significant malpractice at which Rule 10b-5 has been thrust is unfair insider trading—the use of important, unpublicized corporate information as a basis for a decision to buy or sell the company’s stock or to make a recommendation to others to buy or sell.

The successful use of Rule 10b-5 by the Securities and Exchange Commission in many recent actions, including those involving Texas Gulf Sulphur Company\(^9\) and Merrill Lynch, Pierce, Fenner & Smith,\(^10\) has caused the business community great concern. The reasons for the apprehension have been both the increased readiness of the SEC to prevent the misuse of inside information and the difficulty in determining what type of conduct is unlawful and who may be liable for it. Numerous speeches, discussions and writings have sought to delineate what the new rulings mean for the corporate enterprise as well as for corporate officials and employees, stockbrokers, se-

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7. 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 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.
8. Both the perversion of information and the perverted use of virgin information can be violative of Rule 10b-5. The former is illustrated by Escott v. BarChris Contr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968) (false and misleading information in registration statement and prospectus) and SEC v. National Securities, Inc., 393 U.S. 453 (1969) (misrepresentations in connection with solicitation of proxies antecedent to a merger), while the latter is illustrated by cases such as Ruckle v. Roto Am. Corp., 339 F.2d 24 (2d Cir. 1964) (withholding from full board latest financial statements and other facts by defendant directors) and those in which one trades on inside information. In addition, Rule 10b-5 has been invoked in cases where corruption or misuse of information is not the real issue. See, e.g., Pettit v. American Stock Exch., 217 F. Supp. 21 (S.D.N.Y. 1963).
9. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968). See also text accompanying note 45 infra.
security analysts and others.\textsuperscript{11} While the general effect of the recent rulings on the securities market will be salutary, it is ironic that the security analyst, whose primary role is to help assure an informed market, is not only faced with kaleidoscopic liabilities but is hampered in his quest for necessary information from corporate officials.

This Note will first review the methods by which the security analyst obtains corporate information, develops an investment recommendation and apprises the investor of his evaluation. It will then trace the rapid development of securities regulation, plot the potential 10b-5 insider trading liabilities which a security analyst now faces in compiling and distributing his recommendations and discuss particular difficulties which may arise when the new rules are applied to the analyst. Finally, the Note will examine the "blackout" of corporate information caused by uncertainties in the future application of the new rules.

II. INFORMATION FLOW

Perhaps a majority of the 25 million shareholders in the United States fancy themselves security analysts, obtaining information from general and financial periodicals, company reports and news releases, friends and stockbrokers. The goal of both the lay and professional analyst is to accurately predict a company's prospects for profit in the form of dividends and appreciation of the security's value. Unlike the average lay analyst, however, the professional is usually prepared to utilize every source of information and appraise every element necessary to make an accurate analysis.\textsuperscript{12}

\textsuperscript{11} The 1968 fall conference of the Financial Analysts Federation featured several forums on corporate disclosure and use of insider information, including one conducted by Philip A. Loomis, Jr., general counsel of the Securities and Exchange Commission. The conference was held in Atlanta from Oct. 6 to 9, 1968. The Practicing Law Institute held similar forums in New York City beginning on Oct. 10, 1968, and in Las Vegas beginning on Nov. 7, 1968, as did the Continuing Legal Education service of the University of Michigan Law School in St. Louis on Jan. 16 and 17, 1969. See also W. Painter, Federal Regulation of Insider Trading (1968); A. Bromberg, Securities Law: Fraud—SEC Rule 10b-5 (1967) (with supplements).

\textsuperscript{12} A thorough analysis and sound conclusion is not, however, characteristic of all research procedures and investment advice. The time which is spent and the sources which are utilized on each analysis, as well as the ability and training of the analyst, vary greatly. See Special Study, supra note 2, at 145-46, 334-71. B. Graham, D. Dodd & S. Cottle, Security Analysis: Principals and Technique 106-07 (4th ed. 1982); Zitnik, Research Report Ethics, Financial Analysts J. 73 (Jan.-Feb. 1966). See also note 15 infra.
These sources of information include government statistics, trade journals, company financial statements, stockholder reports, news releases and personal meetings with company officials. The personal meeting may be either a management presentation before the local society of analysts or a private discussion between a company official and an analyst. The professional analyst, like the lay analyst, will also occasionally re-

13. Sources of financial information also include *Standard & Poor's Corporation Records* and *Moody's Industrial Manual*. A less widely used source is the annual 10-K report, and others, filed by companies with the SEC. *See* Special Study, *supra* note 2, at 353-55.

14. *See generally* B. Graham, D. Dodd & S. Cottle, *supra* note 12, at 77-94; The Wall Street Journal, Oct. 9, 1968, at 1, col. 6. Other sources which are at times equally important include a company's suppliers and competitors and also acquaintances in the firm itself, such as a duplicating machine operator. *See* The Wall Street Journal, Feb. 11, 1969, at 1, col. 4.

15. As might be expected, evidence of a certain amount of "cribbing"—the use of another's work to voice judgments ostensibly one's own—has also been uncovered. This practice, probably disproportionately common among unreliable investment advisory services, sometimes approaches complete reliance upon another's conclusion. In such a case, the source is not one of information for an analysis but is one of an analysis itself. *See* Special Study, *supra* note 2, at 341-49.

"Cribbing" a conclusion is similar to, but upon ethical grounds distinguishable from, the prevalent "cross-use" of analyses. Often, a small brokerage firm has a correspondent relationship with a larger brokerage firm or with an advisory firm, whereby it receives advisory materials for internal use or for distribution. Materials distributed to the small firm's customers either carry its own heading or that of the original distributor. *See* Special Study, *supra* note 2, at 355-56. Numerous other "cross-use" relationships also exist, including use of outside material by a mutual fund managing company or a bank trust department. *See* note 22 *infra*; Special Study, *supra* note 2, at 356, 360. "Cross-use" can usually be distinguished from "cribbing" upon one or both of the following bases: (1) expected reliance of a small brokerage house upon one well-equipped to do accurate analysis as against the implied representation of a subscription publisher that its recommendations have been researched by the firm itself; and (2) use of another's conclusion to supplement one's own independent study as against complete reliance upon another's conclusion.
ceive a tip or hear a rumor about company developments. *Elements of appraisal* include any information that will affect earnings, including data on the company’s sales, costs, capitalization basis, cash condition, marketing organization, labor relations, research and development, and managerial policy and ability, as well as data on the industry and economy.16

An item of information received through one of the above sources is occasionally of such importance that it has a value by itself in recommending an immediate investment transaction. Most of the information, however, is analyzed on the basis of objective tests and subjective judgments and is assimilated into a periodic report or a running account on the security's desirability. Objective tests are performed on the book value per share, ratios of liquidity and capitalization, and rates of return. Subjective judgments are made on the strength and vitality of the corporate managers, of the marketing and labor situations and of the industry. Thus the information received is either of special import and made the basis of an immediate recommendation or of general import and incorporated into reports or running accounts.

The resulting use of both the completed analysis and the item of special import depends upon the type of analyst receiving the information. The brokerage firm analyst uses matter of general importance for intrafirm communications or for market reports distributed by the company,17 or he incorporates it into his running judgment to provide advice to the investors seeking it.18 The items of special significance may be used to notify special19 or selected20 customers, be used as a basis for a

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17. Intrafirm materials consist of recommendation lists sent out by a large brokerage firm's research department to branch offices for the use by the selling staff. Market reports include brief letters with short analyses of many securities sent by a firm periodically or irregularly to those on its mailing list. The mailing list often includes potential as well as present customers. A report may also be a lengthier study of a single company. Such reports are usually circulated only among the larger “special” customers of a firm. The special customers may also get other specially prepared reports.

18. An analyst’s running judgment or running account will be used as a basis for a later reanalysis and as a fund of information with which to answer inquiries of a salesman. See Special Study, supra note 2, at 330-31, 345, 350-51.

19. Large customers of a brokerage firm or investment advisory service might be termed “special” customers. Special customers, such
transaction by the analyst or another member of his firm or be made the subject of a general report. Analysts in companies which manage mutual funds and bank trust departments, on the other hand, do not prepare reports for public dissemination, but rather use the information of both general and special importance for investment decisions within the firm or as a basis for personal transactions. Analysts in an investment advisory firm or investment counseling firm use both the general and special information as a basis for newsletter recommendations, for rapid notification of special customers or for transactions in firm or personal accounts.

as institutional investors, are often lucrative accounts and they generally receive priority treatment with regard to research skill and advice. SPECIAL STUDY, supra note 2, at 357-58.

20. A practice common among some brokerage firms is to notify a certain number of customers about a change in value outlook of a certain security. The firm might have an alphabetical list and notify different groupings of successive developments in various securities so that the advice is spread among many customers. Such customers may be termed “selected.”

21. It is conceivable but improbable that a brokerage firm would decide to publish news of special significance in a market report before making another use of it. The time lost would probably render the news worthless.

22. In a large trust department, trading decisions are based upon studies by the department analysts themselves and upon information and advice provided by the research department of a brokerage firm and by other outside sources. The medium and small-sized trust departments rely largely on outside sources. The “correspondent” analyst, who is often the brokerage analyst, meets personally with the bank analyst and keeps him informed of new developments by phone. News of recent developments often reaches the bank analyst first since each salesman in a brokerage firm’s “institutional” department handles fewer customers than the salesman in the “retail” department. Developments which are publicly disseminated, such as a new earnings report, reach the bank directly and are not the subject of a brokerage house-bank communication. The brokerage house is paid for its information and advice in the form of commissions on the resulting stock transactions. Payment to independent advisory and counseling firms is by direct fee since such firms are not brokers. Interview with John B. Bryngelson, Vice President, Trust Department, First National Bank of Minneapolis, in Minneapolis, Minn., Feb. 20, 1969.

23. Many investment advisory services publish subscription newsletters which provide advice on which stocks to buy, and, on occasion, which to sell. Examples are the Dow Theory Forecast, Standard & Poor’s Outlook and Babson’s Reports. Some advisory services offer a “consultation privilege” which provides answers to subscribers’ inquiries and a few offer personal portfolio recommendations. See SPECIAL STUDY, supra note 2, at 331, 334-44, 360-62.

An investment counseling firm, on the other hand, provides tailored advice on a fee basis to customers with minimum investment assets of $50,000 to $100,000, or to large investing concerns such as a mutual fund, bank trust department or life insurance company. The securities
III. THE DEVELOPMENT OF SECURITIES REGULATION

A. COMMON LAW

The practice of trading on inside information is largely a development of the last 80 years. Only in an era of corporate ownership by remote nonmanaging shareholders could such a practice have an opportunity to flourish. While early courts uniformly imposed liability upon an insider for making affirmative misrepresentations when buying or selling stock, they developed divergent rules for insiders who merely failed to disclose important information to the other party. The rule which obtained initial majority acceptance viewed the transaction as one at "arm's length" and therefore imposed no duty upon the corporate official to disclose confidential information. A rule born of a different judicial philosophy placed a "fiduciary duty" on the corporate official to disclose important information when dealing in stock transactions with the company's shareholders. The rule which occupied the middle ground—the "special facts" or "special circumstances" doctrine

research is done by a separate department, and not by the counselor. While the sole concern of many advisory firms is investment counseling, some subscription services and some brokerage firms also "counsel." See SPECIAL STUDY, supra note 2, at 369-70.


25. E.g., Gladstone v. Murray Co., 314 Mass. 584, 50 N.E.2d 958 (1943); Connolly v. Shannon, 105 N.J. Eq. 155, 147 A. 234 (1929), aff'd, 107 N.J. Eq. 150, 151 A. 905 (1930); Carpenter v. Danforth, 52 Barb. 581 (N.Y. 1868). The arm's length rule is based on the theory that "neither party owes to the other any higher standard of fairness than is applicable in the market place to an ordinary purchase or sale of a chattel." A. FREY, C. MORRIS & J. CHOPER, CASES AND MATERIALS ON CORPORATIONS 683 (1966). In reviewing early cases on insider trading, an early commentator stated that for a director to take advantage of his position to secure the profits that all have won, offends the moral sense; no shareholder expects to be so treated by the director he selects; no director would urge his friends to select him for that reason; that the law yet allows him to do this, does more to discourage legitimate investment in corporate shares than almost anything else... Wilgus, Purchase of Shares of Corporation by a Director from a Shareholder, 8 Mich. L. Rev. 267, 297 (1910). But see H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1965), where it is argued that use of inside information benefits the stock market and the corporate employer.


imposed the fiduciary obligation when justified by the existence of special facts or circumstances.\textsuperscript{28}

The "special circumstances" rule has apparently attained the status of the majority rule today.\textsuperscript{29} Although this represents a significant shift in policy from the older rule, it does not provide all-weather protection for the investor. Since the insider owes a fiduciary duty only to a shareholder, a purchaser is not protected, since he is not a shareholder until the sale is completed.\textsuperscript{30} Furthermore, it is unlikely that a shareholder selling on a stock exchange is encompassed within either rule.\textsuperscript{31} Thus, the great majority of today's stock transactions are covered by neither the most prevalent nor the most liberal common law rule.

\section*{B. Federal Securities Regulation to 1960}

Confronted with a constituency which traded increasingly in corporate securities and beset by an economy whose failures were painfully illustrated by the stock market crash of 1929, Congress passed far-reaching regulatory laws in 1933 and 1934.\textsuperscript{32} While insider trading on the basis of undisclosed information may well have been a prime concern of Congress,\textsuperscript{33} it was

\begin{itemize}
  \item \textsuperscript{28} In \textit{Strong v. Repide}, the general manager (and controlling shareholder) of a firm owning land in the Philippines employed a straw man to purchase the plaintiff's shares. The plaintiff was not aware of the imminent and favorable sale of the lands to the U.S. Government. In upholding the plaintiff's claim of fraud, the Court said that, \\
  \begin{quote}
  \textit{it is here sought to make defendant responsible for his actions, not alone and simply in his character as a director, but because, in consideration of all the existing circumstances \ldots it became the duty of the defendant \ldots to state the facts before making the purchase.}
  \end{quote}
  213 U.S. at 431 (emphasis added).
  \item \textsuperscript{29} 3 L. Loss, \textit{infra} note 27, at 1447.
  \item \textsuperscript{30} Id.
  \item \textsuperscript{31} Most cases have involved face-to-face dealing and no plaintiff selling on a stock exchange has prevailed. Goodwin \textit{v. Agassiz}, 283 Mass. 358, 362, 186 N.E. 659, 661 (1933); 3 L. Loss, \textit{infra} note 27, at 1454-55; H. MANNE, \textit{infra} note 25, at 22.
  \item \textsuperscript{32} \textit{See H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934); S. Rep. No. 792, 73d Cong., 2d Sess. 9 (1934); S. Rep. No. 1455, 73 Cong., 2d Sess. 55, 68 (1934).}
  \item \textsuperscript{33} Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duty by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their com-
clearly not a prime target of the laws as enacted. The Securities Act of 1933 was aimed at reducing the initial distribution of unworthy securities by requiring the disclosure of extensive information on the corporation's affairs in general and the proposed issue in particular. The Securities Exchange Act of 1934 sought to prevent unfair trading practices subsequent to distribution by setting controls on the securities markets and by providing, in section 16b, that profits made by officers, directors and 10 percent owners on shortswing transactions could be recovered by the corporation. However, this provision left unregulated many insider trading practices and a broad anti-fraud provision—section 10b—was fated to fill the chasm. With the declaration of Rule 10b-5 by the SEC in 1942, the versatility of section 10b was recognized and a new chapter in federal corporation law was titled; nevertheless, the script remained largely unwritten until the 1960's.

Rule 10b-5 as promulgated provided in part that no person shall, in connection with the purchase or sale of a security, use a national securities exchange or any instrumentality of interstate commerce to engage in an act, practice or course of business which operates as a fraud or deceit upon any person. The Rule received its most significant early interpretation when

36. 15 U.S.C. § 78p (1964). A shortswing transaction is one in which the 16b insider purchases and sells or sells and repurchases a security within six months.
37. Rule 10b-5 provides in full that:
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,
(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.
17 C.F.R. § 240.10b-5 (1967).

The original purpose of Rule 10b-5 was to prevent frauds by purchasers since such frauds were not covered by Section 17 of the Securities Act of 1933. See SEC Exch. Act Rel. No. 3230 (May 21, 1942).
a federal court in *Kardon v. National Gypsum Company* held that an individual could recover damages resulting from a violation of the Rule. Up to 1960, however, the *Kardon* holding did not encompass any policy against most insider trading because Rule 10b-5 was not thought to make unlawful any conduct beyond that proscribed by the common law "special circumstances" rule.

### C. The Recent Surge

In 1961, the Securities and Exchange Commission broke new ground for what proved to be a business arena filled with insider trading liabilities. In *In re Cady, Roberts & Company*, decided by the SEC, delineated in several respects the bounds of Rule 10b-5. In that case, a corporate director notified a broker of a dividend decrease just voted by the board of directors. The broker then sold shares for discretionary accounts before the news had been disclosed over the Dow Jones broad tape. In sanctioning the conduct of the broker with a fine and suspension, the SEC held that the obligation to disclose inside information

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39. It has long been disputed whether Rule 10b-5 created anything more than federal supervision of the special circumstances doctrine or made unlawful anything other than common law fraud. Thus, it has been held that a fiduciary relationship is necessary for nondisclosure of a material fact to be actionable, Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964), and each common law element has been held to be necessary to a plaintiff's cause of action. *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951); *Hoover v. Allen*, 241 F. Supp. 213 (S.D.N.Y. 1965). Other courts have found, however, that the scope of 10b-5 is not limited by the common law standards of fraud. *Stevens v. Vowell*, 343 F.2d 374 (10th Cir. 1965); *Berk v. SEC*, 316 F.2d 137 (2d Cir. 1963); *Ellis v. Carter*, 291 F.2d 270 (9th Cir. 1961). The latter position is that of the SEC. *See In re Cady, Roberts & Co.*, 40 S.E.C. 907, 913-14 (1961) (dictum).


imposed by Rule 10b-5 is not limited to those traditionally defined as insiders. The Commission further declared that the obligation is imposed where one trades over a stock exchange as well as where he trades in person and that it protects a purchasing investor as well as a selling shareholder.

The second major case of the decade, SEC v. Texas Gulf Sulphur Co., has had a much greater in terrorem effect and has thus overshadowed Cady, Roberts. An initial drilling for minerals by Texas Gulf Sulphur (TGS) indicated that the land had tremendous mineral potential. Drilling was discontinued for four months while the company purchased surrounding land. During this period, and also after substantiation of the early results had been made by additional drilling, numerous directors, officers and employees personally acquired stock and stock options, and either divulged the information or simply recommended the stock to outsiders. The Court of Appeals for the Second Circuit held that all but one of the defendants violated Rule 10b-5 by misusing inside information. In reversing the district court, the Second Circuit rejected the lower court’s finding that the information was not material. The test of materiality, said the court of appeals, is whether a reasonable


43. It would be anomalous indeed if the protection afforded by the anti-fraud provisions were withdrawn from transactions effected on exchanges, primary markets for securities transactions. If purchasers on an exchange had available material information known by a selling insider, we may assume that their investment judgment would be affected and their decision whether to buy might accordingly be modified. In re Cady, Roberts & Co., 40 S.E.C. 907, 914 (1961). The Commission then footnote a statement saying that the Exchange Act was intended to remedy abuses in the exchange markets. Id. at 914 n.25.


45. 401 F.2d 833 (2d Cir. 1968).

46. See text accompanying notes 107 & 108 infra.
man would attach importance to the fact in making an investment decision.\textsuperscript{47}

Soon after the decision in \textit{Texas Gulf Sulphur}, the SEC brought a 10b-5 action against the brokerage firm of Merrill Lynch, Pierce, Fenner & Smith; numerous of its employees, and 15 large mutual fund customers.\textsuperscript{48} The Commission charged that the firm's underwriting department received information about an earnings drop and a downward revision of the earnings projection from Douglas Aircraft, and that employees in the securities research department and other departments passed the non-public information to the firm's institutional customers. The brokerage firm agreed to a settlement, which included the censure and suspension of several employees and the temporary closing of two offices.\textsuperscript{49}

\textbf{IV. THE EFFECT OF THE EXPANDED SCOPE OF 10b-5 ON SECURITY ANALYSTS}

A. POTENTIAL LIABILITIES

1. \textit{The Analyst's Vulnerability}

The threshold question which arises when examining the security analyst's potential liability under 10b-5 is whether the analyst is within the ambit of the Rule. Until recently, it was argued that the Rule applies only to the traditional insider, such as the corporate director or officer and the large shareholder. The reasoning was that since the common law rule against insider trading and the shortswing profit-taking rule of Section 16b\textsuperscript{50} apply only to these persons\textsuperscript{51} and since Rule 10b-5 contains only general anti-fraud language without any mention of trading on inside information, any incorporation of an insider trad-

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\textsuperscript{47} The second significant aspect of the decision was the pronouncement that Texas Gulf Sulphur Co. itself may have violated Rule 10b-5 by issuing a possibly misleading press release prior to confirming the rumors of a major ore strike. The issue of whether the news report was misleading was remanded to the trial court for determination. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 884 (2d Cir. 1968).


\textsuperscript{50} See text accompanying note 36 \textit{supra}.

\textsuperscript{51} See 3 L. Loss, \textit{supra} note 27, at 1446.
ing rule into 10b-5 should extend only to the traditional insider.52

This narrow interpretation of the Rule was rejected in Cady, Roberts, which declared that Rule 10b-5 prohibits the unlawful conduct of “anyone” and stated that 10b-5 insidership has as its basis:

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.53

The court in Texas Gulf Sulphur agreed with the SEC’s reading of the Rule, adding that

anyone in possession of material inside information must either disclose it to the investing public, or . . . abstain from trading in or recommending the securities . . . .54

It is thus apparent that outsiders as well as insiders are within the grasp of Rule 10b-5, and that the traditional “rule against

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54. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968). Thus, an analyst’s argument that he did not profit from the news but only used it as a basis for recommendation to others will be unavailing. In fact, two defendants in Texas Gulf Sulphur were found to have violated 10b-5 for tipping off others. See also In re Cady, Roberts & Co., 40 S.E.C. 907 (1961) (broker’s sales for others found to be a violation); Comment, 14 VUL. L. Rev. 140, 147-48 (1968). Failure to fulfill the “access test” of Cady, Roberts, however, would not necessarily preclude one’s being in violation of 10b-5. While the Cady, Roberts, doctrine requires the “existence of a relationship giving access . . . to information,” which the Texas Gulf Sulphur court purportedly adopted, the latter court also declared that “anyone” having inside information is encompassed.

Persons receiving information from an insider—the “tippee”—have, however, often escaped prosecution. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), where the SEC made defendants of none of the six tippees. Nevertheless, the court noted that use of material information by a tippee with actual or constructive knowledge that it is undisclosed might be as “reprehensible” as use by an insider. Id. at 853. See also Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967), where three dentists were tipped off by corporate directors and were held to a duty to disclose. The dentists were, however, familiar with corporate activities and thus the court reasoned that they could probably be termed insiders. In any event, added the court, a tippee who as a “knowing confederate” acts on inside information is liable for aiding and abetting a Rule 10b-5 violation.

The fact that both the Ross dentists and the Merrill Lynch investors were easily identifiable, were certain of the validity of the information and were in a somewhat closer relationship to the inside source than the traditional “man on the street” tippee seems to offer a distinction with a real difference.
"insider trading" has actually become a rule against insider and outsider trading on inside information.65

That Rule 10b-5 will in fact be applied to persons outside the class of the traditional insider is illustrated by the fact that the nonmanaging corporate employee, the stockbroker and members of a brokerage firm’s research department have recently been charged with violations of the Rule.66 Moreover, the most obvious circumstance under which a security analyst would violate the Rule—the misuse of information received in a personal meeting with a company official—falls within the scope of both the Cady, Roberts and the Texas Gulf Sulphur holdings, as noted above. To shield an analyst from liability under Rule 10b-5 would be inconsistent not only with the technical holdings of the case law but also with the purpose67 underlying the broad prohibition against insider trading.68 There-

55. Alternatively, the outsider having inside information could be termed an insider. Rule 10b-5 is applicable to “anyone,” however, and such a perversion is unnecessary and would only serve to complicate an analysis of the emerging rules.


In addition, the SEC has brought action against 10 institutional investors who received information of Douglas Aircraft’s earnings drop from Merrill Lynch employees. See CCH Fed. Sec. L. Rep. ¶ 77,596.

57. See notes 69 & 70 infra, and accompanying text.

58. Of additional importance in analyzing the security analyst’s vulnerability to Rule 10b-5 is the question of general procedural and substantive obstructions for the plaintiff. Items of a procedural nature include federal court jurisdiction, venue, and service of process. Substantive elements of a plaintiff’s cause of action for common law fraud are misrepresentation, materiality, scienter and reliance. Because the common law on insider trading has to some extent been engrafted into 10b-5, whether the common law elements are a prerequisite to a 10b-5 cause of action has been a subject of dispute. See text accompanying note 54 supra. Since mere nondisclosure has become actionable under 10b-5 as well as under the common law majority rule, an affirmative misrepresentation is presently not required for either action. Materiality, of course, remains an important requirement. Scienter is no longer required for conduct to constitute a violation of Rule 10b-5. In its place is an element variously termed “lack of diligence, constructive fraud, or unreasonable or negligent conduct . . . .” SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 855 (2d Cir. 1968). Whether an intent to defraud will be necessary in a damage action has apparently been answered in the negative. Id. at 854-56. Reliance is also of decreasing validity in modern 10b-5 actions. See Sommer, Rule 10b-5: Notes for Legislation, 17 W. Res. L. Rev. 1029, 1043 (1966).

An additional obstacle which might possibly confront a plaintiff in a private action is privity. It probably will not be held to be a requirement since it would likely defeat the action, due to failure of proof, of
fore, it clearly appears that the security analyst is within the purview of Rule 10b-5.

2. What Constitutes Unlawful Conduct

Although the cloud of Rule 10b-5 liability is beginning to settle over a diverse group of persons, including the security analyst, the specific type of conduct made unlawful is largely undetermined. However, one well-established hurdle which must be negotiated by every plaintiff in a 10b-5 action is that of proving the materiality of the information allegedly misused. An item of information is material for Rule 10b-5 purposes if a reasonable man would attach importance to it in determining his choice of action, and therefore, facts which under reasonable and objective contemplation might affect the value of the stock meet the materiality requirements of the Rule.


59. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968); List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965); RESTATEMENT OF TORTS § 538 (2) (a) (1938).

60. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968); List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965); Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963). The Texas Gulf Sulphur opinion lends support to two conflicting definitions of materiality: The definitions quoted in the text, and one professing that the duty to disclose or abstain from trading 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 disclosed." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), citing Fleischer, Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding, 51 Va. L. Rev. 1271, 1289 (1965) (emphasis added). The definitions in the text accompanying this note and note 59 supra, however, appear to be given somewhat more weight. If these definitions become permanently established, then the court would indeed seem to have set a "very low threshold of materiality." Bromberg, Implications of Texas Gulf Sulphur, 1 THE REV. OF SECURITIES REGULATION 985 (1968). Bromberg suggests that the courts might adopt as a rule of thumb a certain percentage change in probable effect of market value as the standard for materiality. Id.

Former Securities and Exchange Commissioner Francis M. Wheat suggested, prior to the Court of Appeals decision in Texas Gulf Sulphur, that the facts be of "such a nature that their disclosure could reasonably be expected to have a substantial impact on the market . . . ." Fleischer, Corporate Disclosure/Insider Trading, 45 HARV. BUS. REV. 129, 130 (Jan.-Feb., 1967). Materiality has also been defined as "[m]atters which such an investor needs to know before he can make an intelligent, informed decision whether or not to buy the security." Escott v. Bar-Christ Contr. Corp., 283 F. Supp. 643, 681 (S.D.N.Y. 1968).
enunciated because the cases to date have involved information of extraordinary value, general lines can be drawn by reviewing court decisions and writers' suggestions. Courts have found "material" information regarding a stock split,61 merger,62 an impending liquidation of an appreciated inventory63 and an impending sale of corporate assets.64 Commentators have added to this list information of an important product discovery, a proposed liquidation and the winning of a major contract.65

Applying the test of materiality involves a balancing of two factors: magnitude and probability. A determination of the magnitude requires both an estimate of the absolute size of the development and a consideration of the effect of the development "in light of the totality of the company activity."66 For example, the winning of a $10 million government contract would not have the same impact on General Dynamics as it would on a smaller company. A determination of the probability requires a prediction of the likelihood that the event will occur.

Further analysis of the conduct prohibited by the Rule necessitates a retreat of one step. An issue which will be relevant in some cases and which analytically requires a determination prior to the issue of materiality is whether fragments of information, which become material only upon an evaluation of the aggregate, can constitute the "material inside information" whose misuse is prohibited. In the cases heretofore considered, the specific information received was that an important event either had occurred or was likely to occur. Since a unity of material information and event existed, no synthesis was required for the defendant to utilize the information. Thus, application of the inside information rule was inescapable.

Cases will undoubtedly arise, however, in which a unity of material information and event does not exist. Even a bare apprehension of an event might be recognizable only through a synthesis of fragmented information. Furthermore, one case may involve fragments received exclusively from insiders while

another involves fragments received from both inside and outside sources.67

Consequently, both unity and nonunity cases involve a determination of materiality, while the nonunity (synthesis) cases also require an initial determination of whether the insider trading rule is applicable. In establishing a framework of liability, it will be helpful to hypothesize several situations based on variations of the Texas Gulf Sulphur case.

(a) Unity & Outside Source

A security analyst may hear news of a corporate development from an outside source. For example, news of the TGS ore strike may have been first obtained by an analyst through a company press release. Acting68 on the basis of this information is clearly lawful, since the information is public. There is no "overreaching" by one in possession of undisclosed information69 and "equal access" to information is preserved.70

67. Of course, persons other than the security analyst are also likely to possess fragments of information, the synthesis of which may lead to a realization of a corporate event. These persons include the journalist, the corporate officer, director, employees and their friends. The analyst, however, is in the midst of a stream continually flowing with corporate data and thus he is especially likely to confront such a question.

68. "Act" as used in this Note means any method by which material inside information can be misused. While insiders usually act by trading for themselves, analysts usually act by recommending the security to others. The brokerage analyst's recommendation usually reaches the customer through a market report or customer's man; the investment advisory analyst's recommendations are funnelled through the service's publication, and the trust department and mutual fund analyst's recommendations are provided to the "customer" in the person of an investment committee. Using material inside information either to trade for one's own account or for recommending it to others is clearly a violation of Rule 10b-5. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968); In re Cady, Roberts Co., 40 S.E.C. 907 (1961). In re Merrill Lynch, Pierce, Fenner & Smith, SEC Exch. Act Rel. No. 34-8459 (Nov. 25, 1969). Attempting to fulfill the duty to disclose by releasing a market report would probably in itself be insufficient because of the small circulation and resulting limited effectiveness.

69. The crux of the theory behind many securities laws provisions is found in the statement that "[t]he essential objective . . . is to protect those who do not know market conditions from the overreaching of those who do." Charles Hughes & Co., Inc. v. SEC, 139 F.2d 424 437 (2d Cir. 1945), cert. denied, 321 U.S. 786 (1944).

70. "The 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. It was the intent of Congress that all members of the investing public should be subject to identical market risks. . . . Such inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in
(b) Unity & Inside Source

An analyst may hear news of a corporate development from an inside source. For example, an analyst may have first heard about the TGS ore strike from a company official. If the analyst acts on this statement prior to public disclosure, he violates Rule 10b-5. The result is the same as if an insider tips off an outside acquaintance, since in both situations, the investing public is relegated to an inferior level of access to information. The analyst and those whom he notifies should not be allowed to profit from the analyst's special relationship with an inside tipper. Similarly, the analyst can be expected to recognize the materiality of the information and realize that trading based thereon would violate the Rule.

(c) Nonunity & Outside Source

An analyst may, by the use of sources of information open to the public, perceive the existence of a significant corporate development. For example, he may have thought that TGS had made a significant strike on the basis of the following hypothetical items: a recent annual report of the company stating that the budget for Canadian explorations had been doubled; a news report stating that TGS chartered a plane to deliver cores to the U.S. for assaying; another news report revealing that three top company officials visited Timmins, Ontario, and a rumor along view of the congressional concern in the area, remain uncorrected.”


71. Since trading must await “effective” disclosure, a problem common to all in possession of inside information concerns the length of time after disclosure during which action is prohibited. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854 (2d Cir. 1968).


73. One factor of importance in any insider trading suit is the “state of mind” of the defendant. Scienter was a requirement in the traditional insider trading case. This common law requirement has been modified, however, so that mere negligent conduct is all that is required. See Stevens v. Vowell, 343 F.2d 374 (10th Cir. 1965); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961). Negligent analyst conduct seems to be clearly present in the instant hypothetical discussed in the text and in the subsequent hypotheticals which suggest that certain conduct is proscribed by the Rule. Although conduct more grievous than negligence may be required in a damage suit against a non-profiting corporation for a misleading press release, see SEC v. Texas Gulf Sulphur Co., 401 F.2d at 866 (2d Cir. 1968) (concurring opinion), the case of the analyst-defendant seems to be different since the analyst benefits, although indirectly, from his recommendations.
Wall Street that TGS is hurriedly purchasing land near Timmins.  

It cannot be seriously contended that it is unlawful to act on the basis of an evaluation of this information. As in the case where an analyst hears news of an important corporate event through a company news release, these fragments of information do not constitute inside information. In both situations, all interested investors have relatively equal access to the items, and the law does not invalidate a transaction because one party neglected to evaluate the bargain. This justification derives from the "personal expertise doctrine," which states that one may trade on the dictates of an investment judgment based on one's analytical ability or superior guesswork. The only limitation is that "material inside information" not be used in formulating the judgment.

(d) Nonunity & Inside Source

A synthesis of items of information received during an in-
Interview with a corporate official may lead an analyst to believe that there has been or is likely to be an important corporate development. For example, a company official may have told an analyst over the course of a three hour interview that he had just visited Timmins, that the Canadian exploration budget had been doubled, that a plane had been chartered to deliver cores and that the company was purchasing land near Timmins. Other developments which an analyst might perceive from fragments obtained in this manner include a merger and a significant change in sales or earnings.

Since the insider did not make an outright statement that an event has occurred or that one was likely to occur, assuming that the corporate event is material, the question reduces to whether the Rule applies to an analyst who synthesizes the inside items and acts on the basis of his conclusion. It might be argued that the items received were not in themselves material and that, therefore, personal expertise was the catalyst causing the analyst to act. However, present law states that information which would be of importance to a reasonable investor in deciding on a course of action is material. While this standard was formulated in cases involving a single item of news and not several, it would seem to be well adapted to handle both situations. Thus several items, taken together, could constitute material inside information, and if a reasonable investor would find the items important in making an investment decision, the analyst would be liable.

The conclusion that this is the proper course of development for the Rule is buttressed by the fact that it advances the underlying purpose of Rule 10b-5, that being to preserve equal access to important corporate news so that all investors share a like bargaining position. Furthermore, such a ruling would not cause in terrorem withdrawal from the investment recommend-

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78. Information received from a company official during a presentation before a group of analysts might also constitute material inside information. Although these meetings are now generally open to journalists, it would seem that the company official is nevertheless under a duty to "effectively" disseminate any important, nonpublic information given, while the analyst is under a duty not to act on such news until dissemination. One solution would be for the company official to issue a news release prior to the meeting backgrounding news items on the agenda.

79. In these situations, the test of materiality not only involves a balancing of the "traditional" elements of magnitude and probability that the event will occur, but also assumes a third element: probability that one's deduction that an event has or is likely to occur is correct.
ation business, since the analyst should certainly be able to ascertain when he has made a conclusion based on information received entirely from a discussion with a corporate insider. He can then simply refrain from acting on that conclusion. In addition, since the analyst is an experienced evaluator of corporate information, he would seemingly be better able to detect an impending breakthrough than the “reasonable investor,” and thus escape liability.\(^80\)

(e) Nonunity & Several Inside Sources

An analyst may also perceive the likelihood of a corporate development from items received in interviews with several insiders. For example, an analyst may have apprehended the possibility of the TGS strike on the basis of the items mentioned in the previous hypothetical after talking with several members of the company management, each of whom mentions a separate fact. The fact that there is a different number of insiders contributing to the analyst’s aggregate of information, however, does not seem to warrant a different rule of law. More than one source makes the materiality test no more difficult to apply.\(^81\) Similarly, the investing public would be denied equal access to important information, just as if only one source were used. Moreover, the analyst should be equally able to recognize this situation and its inherent danger signals and thus refrain from acting on the basis of his conclusion.

An ancillary question is whether the insiders in the multiple source situation are liable for their conduct. Since no insider alone provided material information, it could be argued that none would be individually liable. However, since the corporation’s agents in the above hypothetical did as a group disclose material information, an investor could convincingly argue that the corporation is a “person” within the meaning of Rule 10b-5 and is thus liable. Hence, a corporation would be under a strong compulsion to tighten up corporate procedure for discussion with analysts, journalists and others.\(^82\)

\(^80\) The expense and anguish of a lawsuit may, however, counterbalance the consolation of escaping liability. Besides, “acting” might establish a presumption of misconduct. See note 89 infra.

\(^81\) See text accompanying note 79 supra.

\(^82\) For example, General Mills, Inc., not only provides all officials with written guidelines for use in determining what matters may appropriately be discussed with analysts, but usually one official familiar with disclosure problems accompanies the analyst for the duration of his visit to the company. Interview with Henry H. Porter, Jr., Vice President and Treasurer, General Mills, Inc., in Minneapolis, Minn., Feb. 4, 1969.
(f) Nonunity & Both Inside and Outside Sources

An analyst may perceive a corporate development by synthesizing items received from both inside and outside sources. For example, an analyst may have apprehended the existence of the TGS strike only after obtaining information from newspapers that TGS was purchasing land near Timmins and that the company had just chartered a plane for delivery of cores, and information from insiders that top company officials had made an unprecedented trip to Timmins and that the budget had been revised to adjust for expanded Canadian exploration. This situation differs from the previous two only in the respect that some of the items necessary for the perception are received from outside sources.

A first glance analysis is likely to suggest that since the inside information is not by itself material after synthesis, the Rule is not applicable. Such a position, however, is not tenable since if the reasonable investor can be assumed to know the outside items, inside items may be rendered material if a reasonable investor is capable of synthesizing them. It would seem appropriate to endow the reasonable investor with knowledge of outside items which a shareholder or prospective shareholder who follows the company's fortunes would probably know. Such an application of the Rule would, at any rate, be consistent with the purpose of the securities laws and would not be inequitable to the interests involved.8

In almost every case of synthesis involving inside facts, some outside facts will be indispensable to a finding of materiality. These outside facts include the condition of the economy and industry, the size of the company, the ability of management to take advantage of the development and the role of consumer demand and influence, as well as items more closely related to the development itself, such as the outside items obtained in the instant hypothetical. Thus, to hold that there is materiality only when the inside items by themselves are material would be to declare the Rule impotent.

Of course, there is a danger that this framework of liability would discriminate against the security analyst. The analyst, as guarantor of an informed market, constantly makes reports and provides oral advice. His evaluations are based on an

83. The purpose is to guarantee equal access to inside information and the interests involved are the protection of investors and assuring the free flow of investment advice.
analysis of a large amount of information, a substantial part of which may be from inside sources. If a prima facie case of liability were established every time an analyst perceived a material development while having possession of some inside items, his work would indeed be perilous. The risk is increased considerably by the fact that his conduct under these circumstances would be subjected to the hindsight of courts after the major development had occurred. A logical solution would be for courts to define "inside items" in such a way as to protect analysts if the material development could be perceived by the "reasonable investor" on the basis of exclusively outside facts. This would seem reasonable since any inside fact leading to the same conclusion as that obtained from items available to the public cannot be said to be material.

Therefore, misuse of an inside item which is a minor but integral element of the synthesis process would result in liability to the analyst; at the same time, however, the rule would work to the advantage of the analyst since if a reasonable investor could synthesize the outside facts he is presumed to know and thereby reach the same conclusion as the analyst, the analyst would not be liable under Rule 10b-5.

Finally, when applying the insider trading rule to the security analyst, courts should be willing to avail themselves of the inherent flexibility of the materiality test so as to advance both the public's interest in equal access to information and its counterbalancing interest in obtaining accurate and complete market evaluations.

3. Particular Difficulties in Applying the New Rules to the Security Analyst

Rule 10b-5 insider trading suits have heretofore generally involved a defendant who obtained inside information and traded on the basis thereof. However, new problems and considerations will face the parties and the courts when a security analyst is sued. The questions presented are likely to include: (a) Who will sue the analyst for an infraction of Rule 10b-5? (b) How will the plaintiff become aware of the analyst's infraction? (c) How will it be determined whether the analyst's recommendations were based on inside information? (d) How will it be determined whether the information was material? (e) What is the proper conduct for an analyst who possesses material inside information? (f) What remedies are available for use against the defendant analyst?
(a) Potential plaintiffs

The most prominent plaintiff in the landmark 10b-5 cases has been the Securities and Exchange Commission, but a cause of action for a violation of 10b-5 also extends to individual plaintiffs. The most obvious individual plaintiff is the investor who purchases from or sells to either the profiting defendant or, in the instant situation, to the profiting investor who trades on the defendant analyst's advice. However, it is difficult, if not impossible, to match the buyer with the seller in a securities exchange transaction. Furthermore, the advisability of awarding damages solely to such a plaintiff has been questioned. While it would seem fairer to split the damages between all plaintiff investors who were defrauded, this solution might encourage scores of investors to sue on the basis of one violation and would require a time-consuming determination by the court of who is entitled to share the award. Awarding the damages to the corporation itself would appear to be as practical a solution for the situation where the analyst misuses undisclosed information as where the insider misuses it.

(b) Locating misconduct

Locating instances of analyst misconduct will be at least as difficult as spotting violations by insiders. Perhaps the best method is to investigate unusual activity in a company's stock, especially if the flurry of transactions is followed by disclosure of an important corporate event. The stock exchanges and the SEC do, at the present time, investigate such occurrences and can identify the parties involved in predisclosure transactions.

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85. See text accompanying note 38 supra.
86. It is hardly rational that on a day when a hundred thousand shares of a security are traded the person whose sell order happened to cross the insider's buy order should recover damages while the seller whose order preceded or followed that order by an instant is able to recover nothing even though he is equally harmed by the non-disclosure.
87. See Diamond v. Oreamuno, 29 A.D.2d 285, 287 N.Y.S.2d 300 (1st Dept. 1968), where the court found that a cause of action was stated by a stockholder who alleged that the officer-directors sold shares to third persons on the basis of inside information. Finding that the stockholders derivative suit could stand, the court said such trading could inflict injury upon the corporation by loss of good will and prestige, divided interest of the officer-directors, and competing sales in the market had the company been planning to sell stock.
Since it is difficult for a private investor to identify the parties involved, he must necessarily rely to a large extent upon the investigations of the exchanges and the SEC.

(c) Basis for recommendation

Proving that inside information influenced the analyst’s recommendations may be very difficult. While courts have assisted the plaintiff by finding that the defendant has created substantial evidence against himself by trading in the stock, only unusual activity coupled with some evidence of possession of the information has been held to establish a presumption of misconduct. This presumption must be very carefully applied to the security analyst since the analyst is in the business of acting on information. Furthermore, because his function is in the public interest, he should be able to perform it without being unduly subjected to burdensome damage awards. Therefore, before finding the analyst liable, courts should be fully satisfied that he both possessed inside information and recommended on the basis of it. A device of proof which could assist either the plaintiff or defendant would be the analyst’s “work papers,” which often include results of the analyst’s interviews with company officials, mathematical analyses of the company’s strength and written subjective judgments. Thus, on the basis of this device, the analyst might successfully rebut the contention that his recommendation was based on items received from an insider, and show instead that it was the result of expert evaluation of outside information. If the SEC should deem the problem of proof particularly troublesome, it could initiate a practice whereby the work papers could be subpoenaed for court examination.

89. We are satisfied that these purchases . . . , coupled with his readily inferable and probably reliable, understanding of the highly favorable nature of preliminary operations on the Kidd segment, demonstrate that Huntington possessed material inside information such as to make his purchase violative of the Rule and the Act.


90. An individual analyst usually handles the analysis of securities of only one or two industries. He might also take several companies located in his area. He keeps a file on each company, complete with financial data, news releases and results of personal interviews.

91. Under § 21(b) of the Securities Exchange Act, the SEC may “administer oaths and affirmations, subpoena witnesses, compel their attendance, take evidence, and require the production of any books, papers, correspondence, memoranda, or other records which the Commission deems relevant or material to the inquiry.” 15 U.S.C. 78u(b) (1964). The SEC may also prescribe which books and records the in-
Materiality of information

Proving the materiality of the inside information may also be a vexing problem. In seeking to avoid the subjectivity of the materiality test, courts have sometimes hinted that if disclosure causes a price change in the stock, the information is material. Although such a test would usually be feasible and accurate, it may fail in its objective. The fact of a change in the stock upon disclosure of the information does not necessarily indicate that the news was material since if a large investor, such as a mutual fund, were on the brink of a decision to purchase, a recommendation based upon an item of relatively unimportant news could produce a purchase decision. Thus, courts must guard against blind adherence to a price change test for materiality. The analyst would likely be injured more than most defendants by an improper application of the materiality requirement because of his public interest role and because of the extent to which he may be liable.

If the defendant trades in a company's stock while possessing inside information, courts have found this to be evidence that the information is material. Use of such evidence where the defendant is an analyst, however, would be improper since the analyst's job is to recommend, and therefore, he is likely to


The SEC's “Bookkeeping Rule,” applicable to investment advisors, requires that if a published bulletin does not contain the reasons for a recommendation, the advisor must keep a separate memorandum “indicating the reasons therefor.” Advisors Act Rel. No. 149 (Sept. 10, 1963).

Analysts at J. Barth & Co., a San Francisco brokerage house, now keep detailed records of all their conversations with sources, both in and out of the companies they cover. [This] ... assures the brokerage house that every possible source was tapped in making a report—and also provides a record should the Securities and Exchange Commission ever ask where Barth gets its information.


92. An item of information is material if a reasonable man would attach importance to it in determining his choice of action. See text accompanying notes 59-66 supra.


94. A market price change test of materiality has been suggested. See note 60 supra. If such a test were adopted, it would seem that the presumption thereby established should be a rebuttable one. Thus, testimony that the mutual fund had been on the brink of a purchase would be admitted.

95. See note 89 supra.
recommend on the basis of information which is slightly favorable or unfavorable but not "material" information. Furthermore, clients are likely to trade on the basis of the advice given merely because the analyst gave it. Thus, whether or not the client trades is likely to measure his confidence in the analyst's judgment but not the materiality of the information.

(e) Proper conduct

Another difficulty concerns the proper conduct for an analyst if he has received material inside information but cannot induce the company to publicize the news. Companies may often be justified in refusing to disclose the inside information. The analyst may, of course, make a public disclosure himself and thereafter trade in or recommend trading the security, but such conduct would in some circumstances match the impropriety, though not the illegality, of trading without disclosure.

Assuming the analyst does not publicly disclose the information, the question remains as to whether he must follow the mandate of the courts and completely "refrain from trading or recommending" the security.

It could be argued that Texas Gulf Sulphur's warning against recommendation was aimed solely at the casual advisor, and not the professional. Thus, under this reading, the warning would apply only to the nonanalyst defendant, and while the analyst or his co-analyst or a broker would still violate Rule 10b-5 by recommending on the basis of material inside information, he need not completely withdraw from the recommendation business. So long as his recommendation is not influenced by knowledge of the material inside information, no liability will ensue.

This solution has the advantage of allowing more freedom to the firm which finds such action necessary to prevent disruption of its normal business operations. However, if this consideration is not critical, the firm is likely to refrain from trading or recommending, thereby eliminating any risk of liability. Thus, the firm must balance expected return against the inherent risk.

(f) Remedies available

The remedies available vary with the party seeking relief. The Securities and Exchange Commission may use fines, suspensions and censures against brokerage firms and investment

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advisory services registered with it.\textsuperscript{27} It may also investigate violations and publish its findings,\textsuperscript{98} request injunctions against further violations,\textsuperscript{99} and, for more flagrant abuses, inform the Attorney General of the United States for possible criminal prosecution.\textsuperscript{100} The most significant remedy, however, may be an award of damages in a civil action. Although recommending a stock on the basis of inside information violates Rule 10b-5,\textsuperscript{101} whether an analyst doing so will be subject to a suit for damages is still an open question.\textsuperscript{102} When considering the liberal interpretation given Rule 10b-5 thus far, however, courts can probably be expected to allow damage suits against analysts.

The standard most frequently used for measuring damages has been the "out-of-pocket" test,\textsuperscript{103} under which the plaintiff is entitled to the difference between the price at which he bought or sold the security and the actual value at the date of the transaction. This standard would seem appropriate in the traditional face-to-face transaction where one or more plaintiffs is defrauded by one or more defendants, since the amount of loss to the plaintiffs equals the amount of gain to the defendants. Where the defendants trade shares on an exchange, however, the total loss to investors would probably far exceed the gain to the defendants and to hold the defendants liable for all the plaintiffs' losses would indeed be a frightening spectre.\textsuperscript{104} Thus,

\begin{itemize}
  \item \textsuperscript{97} 15 U.S.C. \S\S 78u(e), 78o, 80b-3(d), 80b-9(e) (1964).
  \item \textsuperscript{98} 15 U.S.C. \S 78u (1964).
  \item \textsuperscript{99} 15 U.S.C. \S 78u(e) (1964).
  \item \textsuperscript{100} 15 U.S.C. \S 78ff (1964). Borderline defendants usually are not subjected to this sanction. See United States v. Crosby, 294 F.2d 928, 938-43 (2d Cir. 1961); 3 L. Loss, Securities Regulation 1993 (2d ed. 1961). For a discussion of the remedies the Commission has at its disposal, see Comment, SEC Enforcement of the Rule 10b-5 Duty to Disclose Material Information—Remedies and the Texas Gulf Sulphur Case, 65 Mich. L. Rev. 944 (1967).
  \item \textsuperscript{101} See note 54 supra.
  \item \textsuperscript{102} It is also an open question whether one trading on a stock exchange is liable in money damages. That one will be found to be liable, however, seems to be a foregone conclusion among the commentators. The writings have thus dealt mainly with the problems of who can sue and the measure of damages. See, e.g., Note, Insiders' Liability Under Rule 10b-5 for the Illegal Purchase of Actively Traded Securities, 73 Yale L.J. 864 (1969); Note, A Suggested Locus of Recovery in National Exchange Violations of Rule 10b-5, 54 Cornell L.Q. 306 (1969).
  \item \textsuperscript{104} See W. PAINTER, FEDERAL REGULATION OF INSIDER TRAINING 111 (1968).
\end{itemize}
courts might well limit the damage award to the defendants' gains. Assuming such a standard is established, the most important aspect of the damages problem for the analyst still concerns the extent to which he may be liable.

While one who recommends to others has been found to violate Rule 10b-5 just as one who trades for himself, the problem of a measure for damages is compounded. The analyst does little else besides recommend and his recommendations may result in trades totaling thousands of shares; thus, he would be peculiarly vulnerable to any rule holding one who recommends monetarily liable for the gains derived by investors using his advice. Of course, the analyst who learns of a mineral discovery from an insider and proceeds to recommend with knowledge of the serious consequences should not be heard to complain. However, an analyst's conduct, as illustrated in several hypothetical cases above, may not involve such a flagrant misuse of information. If and when such a case arises, the court and the parties would have several possible alternatives: full money-damage liability; no money-damage liability; or a suit against either the profiting tippee or the divulging insider. In addition, Congress or the Securities and Exchange Commission could prescribe a different rule, such as censuring, disassociation of the analyst from his firm, a flat fine or damages to the extent of one-half of the actual damages.

B. THE NEWS BLACKOUT

After the decision in *Texas Gulf Sulphur* and the commencement of action against Merrill Lynch, the traditional flow of information through the business community became partially paralyzed. The uncertainty caused business officials to ask what news can, must, or should be disclosed. Since the duty to disclose means the duty to publicize, and to publicize everything discussed between a manager and an analyst would be impractical, some corporations cancelled interviews with individual analysts and presentations before groups of analysts.

105. See note 54 supra.
106. See Bromberg, supra note 60, at 985.
108. See The Wall Street Journal, Sept. 20, 1968, at 6, col. 4, where it was reported that the reaction by companies included cancellation of
Many others, while continuing to maintain contact with analysts, answered fewer questions. While much of the stoppage was undoubtedly due to fear of liability, some refusals were probably based upon the company's predisposed yearning to maintain a veil of secrecy and thus, the new "fear" provided a handy excuse.  

Recognizing that a constricted information inflow caused a less accurately evaluated outflow, the Financial Analysts Federation pleaded with corporate officials to maintain an open door policy and the SEC clearly concurred.  

Such attempts to reopen the corporate door, however, have not been completely successful. Because of the possibility that the goal of the securities laws—an informed investing public—may be undermined by their very own enforcement, the types of information which may be lawfully provided to analysts must be clearly established and corporate officials must be encouraged to maintain contact with the security analyst. Especially helpful would be the development of general guidelines which both explain the state of securities law and the legal rules involved, and also provide direction in regard to which matters can and should be discussed with the analyst. For example, one or more of the stock exchanges might undertake such a project after con-
sultation with the interested parties, including the SEC, the analysts, the National Association of Securities Dealers and the corporate community.

Of course, until Rule 10b-5 is further delineated by the courts, complete and definitive guidelines cannot be provided to the corporate official. At the same time, however, reasonable and well considered proposals for conduct, especially if made with the blessing of the SEC, might provide some guidance for the courts, as well as analysts and corporate managers.

V. CONCLUSION

Rule 10b-5 was adopted in 1942 without overtones of caprice and was accepted without undercurrents of alarm. It remained substantially innocuous until the Securities and Exchange Commission expanded its scope with respect to insider trading malpractices in the 1961 Cady, Roberts case. Thus defined, the Rule's application in Texas Gulf Sulphur did not represent a "full grown monster which suddenly descended upon the financial community on a hot summer evening in August, 1968." Instead, the decision ratified the SEC's declarations and supported its readiness to apply the rule in additional circumstances. The fallout affected everyone with access to inside information, including the corporate official, director and employee, the underwriter and the security analyst. The security analyst found himself in a particular dilemma, shut off from corporate information necessary to his work, and subject to potential liability for any information he did receive.

While reopening the corporate door is the necessary solution to the first problem, it will probably be more easily accomplished than resolving the analyst's field of liability in an attempt to deal with the second problem. Assigning liability to certain conduct of the analyst requires a consideration of the scope of the present rule against trading on inside information, its underlying

with the hope that additional guidelines for listed companies, member firms, and analysts may be developed. He said that AMEX is "seeking to identify the questions that most puzzle corporate management, lawyers, public relations counsel and others, to ask ourselves tough questions and to provide answers to interpret what the exchange considers proper disclosure." The Wall Street Journal, Nov. 14, 1968, at 7, col. 2.

113. The NASD, a semi-official association of most brokers and dealers, regulates the over-the-counter market. See 2 L. Loss, Securities Regulation 1365-91 (2d ed. 1961).

114. W. Painter, supra note 104, at vii. Painter says that the use of Rule 10b-5 in Texas Gulf Sulphur signals an "unfolding chrysalis" of federal securities law and not a declaration of new liabilities.
purposes and a survey of the practicalities involved. On one side of the balance is the public policy of investor protection. On the other side is the extent to which the particular conduct advances or hinders that policy. Most conduct advances that policy by providing an information conduit to the investing public, accompanied by expert evaluation of that information. The conduct which undermines that policy is akin to that of the traditional abuse by an insider. These considerations should be injected into the evolving framework to determine the question of whether there has been analyst misconduct. Failure to incorporate these considerations will counteract the goal of the securities laws themselves.