Disclosure of Inside Information - Materiality and Texas Gulf Sulphur

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DISCLOSURE OF INSIDE INFORMATION — MATERIALITY AND TEXAS GULF SULPHUR

By JEREMY L. WIESEN*

INTRODUCTION

On November 17, 1966, the following item appeared in the Philadelphia Inquirer:

Chairman Manuel Cohen of the Securities and Exchange Commission said he's dissatisfied with the policy of many companies to disclose privately to security analysts and big investors significant information about a company's activities before its release generally to the investing public.

"We have recently received indications, which are very disturbing to me, that premature disclosure of corporate information to limited groups of people who are in a position to act on it may be more prevalent than we had supposed," Cohen said.

Without proposing possible solutions, Cohen further noted "some evidence" that corporate disclosure requirements of the Federal Securities laws aren't as effective as they should be.

Cohen expressed general agreement with the view that these requirements "as now being applied, are not producing the quality or amount of information that is essential for informed trading in the secondary markets."

Cohen noted that institutional investors and brokerage analysts, recognizing the "deficiency" of current corporate disclosure requirements, seek information about companies they're interested in through personal talks with company officials.

Cohen said that if these big investors and analysts "are able to obtain from the issuer because of their economic power, or for other reasons, information that is not available to those with whom they are trading in the public market, it raises serious questions of law and propriety."1


The news report is particularly interesting for several reasons. In the first place, research into the field leaves the unavoidable impression that there is still little public verbalization by any source, including the Securities and Exchange Commission, of the great prevalence of private disclosures of inside information. Anyone familiar with the Wall Street community is aware that Chairman Cohen is attacking only the visible portion of a very large iceberg.

Secondly, with the institution of suit against the Texas Gulf Sulphur Corporation, it was generally thought that sufficient progress of a remedial nature was being made in this unspoken-of area. Until the case was concluded, it appeared premature to say that the "Federal Securities laws aren't as effective as they should be" or to suggest that there may be a need for "solutions." The decision of the Court of Appeals for the Second Circuit was filed on August 13, 1968. Its effect on private flows of inside information will be analyzed in this article. Materiality appears to have become the crux of enforcement, and, therefore, this elusive concept must be better understood, or an attempt must be made to find solutions which avoid an exact delineation of its meaning.

Another interesting point about the article is its failure to distinguish the separate problems raised by disclosure of information. This presentation in the Inquirer, perhaps unintentionally, combined several distinct problems. The second section of the article discusses abuses of inside information by way of private disclosures, the third section makes a general complaint about the securities laws as they apply to disclosures, and the fourth section decries the insufficient public dissemination of information. Of course each of these concerns are interrelated, but analysis and understanding of the area requires a separate examination of each of these problems rather than a combined treatment. If materiality is to be the heart of this area, then we must have clear standards by which to determine, for each purpose, the meaning of "material," especially since that determination inherently involves borderline cases.

Finally, the inclusion of institutional investors, along with security analysts, as those who are privy to inside information is significant. Only recently has the conduct of such large traders become of sufficient concern that Congress has called for an immediate study of their total impact on speculative markets. Part of that study, no doubt, will
involve an examination of the existence or absence of abuses of inside information. Even if that point is not central to the study, information on the market activity of institutions will be provided which is not now available and which may be suggestive of the existence of private lines of communication. Data is lacking throughout this whole area, and it is hoped that current efforts to interest economists and statisticians in investigation of this phase of market activity will be successful. In the interim, recognizing the lack of specific data, the reader will have to accept the general statements which follow as a sufficient basis for a condemnation of practices in this area.

I. THE PREVALENCE OF "TIPS" OF "INSIDE" INFORMATION

A. IN GENERAL

Virtually every person who has had contact with the stock market can attest to the phenomenon of tips of inside information, although there is little documentation of this fact. Excerpts from two Wall Street Journal articles state: "... it's generally conceded — and demonstrated almost daily — that major corporate doings have a way of leaking out, with or without a formal announcement [by the company]" and, "It's no secret in broker circles that much of the stock trading carried on at exchanges and in the over-the-counter market as well is based on supposedly inside information."

Except for the role of two "institutions" discussed below, i.e., the financial public relations firm and the security analyst meeting, it is difficult to detail the various processes by which inside information leaks out. The usual manner is through contacts with corporate management, but even this can take many forms. For example, it is reported that the brokerage firm of Merrill, Lynch, Pierce, Fenner, and Smith receives advance news releases from companies in order that they may be prepared by that firm for dissemination over the teleprinter system which connects its many offices. It is conceded by the firm that there is nothing to stop a registered representative from seeing these advance releases.

If a direct contact cannot be established there is always the possibility of obtaining information through other persons who are in privity with management. A public relations man informed the Securities and Exchange Commission's Special Study of the Securities Mar-

S.J. Res. 160 and on July 29, 1968, the President signed Pub. L. No. 90-438. The Wall Street Journal reported on July 17, 1968, at 12, col. 2:

The proposed SEC study of institutional investment would involve a detailed examination of the trading practice of banks, insurance companies, pension and welfare funds, and other organizations. The SEC said the study's purpose would be to collect information that might form the basis for later regulatory or legislative action.

5. The salient example of such efforts was a symposium conducted in Washington, D.C., on March 7 and 8 entitled "Economic Policy and the Regulation of Corporate Securities" sponsored by the National Law Center of George Washington University and The American Enterprise Institute for Public Policy Research.


8. Id. at 12, col. 3.
Some corporate information flows to individuals in a non-clandestine manner; it is, in fact, deemed in the investing public's interest that these individuals receive this information. The best example of this is the "reasonable basis" rule, which has been applied by the Commission and the courts to situations in which securities of little-known companies have been sold by aggressive selling techniques. Those salesmen have been held to have violated the anti-fraud provisions of the federal securities statutes by not having a reasonable basis for representations about the security. The salesman is said to be under a duty to visit the company and discuss with management the affairs of the company. This duty only arises when adequate information as to the company's affairs is not publicly available. This situation sharply focuses the delicate balance which exists between the need of all investors for accurate financial data and the harmful effects of a private flow of this information.

B. The Role of the Financial Public Relations Firm

The financial public relations firm is a species of the public relations industry concerned with creating investor interest in their client's stock. This is achieved, in part, by establishing contacts between the corporation's management and the financial community: "Personal contacts, both with the financial press and the investment community, are the very essence of financial public relations. In their selling literature, financial public relations firms emphasize the closeness of their contacts with financial writers and analysts." The Special Study made a thorough investigation of the financial public relations industry because of its inherent tendency to distribute overly optimistic reports about its clients. This tendency apparently stems from the propensity of management to disseminate exaggerated claims about its company to potential investors through its contacts with public relations firms.

It seems, however, that the real abuse uncovered by the Special Study is the disclosure of inside information to a limited number of persons. It is naive to think that security analysts can be easily duped into believing untrue statements about a company. Like the boy who cried "wolf" too many times, corporations and public relations firms

12. Special Study, supra note 9, at 81.
13. Milton Cohen, Chairman of the Special Study, told this writer that the investigation into the public relations industry was prompted by the bullish market of 1961, and, therefore, it was predominantly concerned with the industry's role in disseminating exaggerated claims about its clients.
cannot create reliance on exaggerated claims over an extended period. Except to the extent that false information is valuable as the basis of a stock "push," analysts and others are searching for information which has merit and which has not been already discounted by the market. The financial public relations firm has a role in that search. The research partner at Sutro Bros. & Co., a brokerage firm, told the Special Study: "The only time . . . a public relations firm can be helpful is when I want to get on the phone or establish a contact with a company personally."  

C. The Role of the Security Analyst Meeting

The security analyst meeting is a gathering at which a high-ranking corporate manager delivers a speech about his company to a group of security analysts. It often includes a question-and-answer period. In 1965 there were approximately 5,500 such meetings. They are usually sponsored by an association or society of analysts but may be arranged for by a financial public relations firm for its client.

It would seem that security analysts would not go to the trouble of attending meetings if all they were to hear was a reiteration of information about the company already in the public sphere, information of which, presumably, they are already aware. During early 1965 many analysts began to complain that they found the meetings boring and some even reported they had fallen asleep at the luncheon table. Their protest was to the effect that "too few companies . . . are providing the beneath-the-surface information they need to make investment recommendations . . ." Their cry was heard and acted upon. Some corporate managers elicited help from research agencies in order to discover what the analysts wanted to hear at the meetings. One poll of analysts revealed that 90% wanted more data on products, 94% on research and development, and 98% said that they desired more information on markets and sales projections. After going to this trouble and expense, there is no reason to think that speakers do not heed the results of the surveys.

In case the officer or director does not have a copy of a research agency's findings in front of him when he is preparing his address, the analyst groups have provided him with suggestions. The Investment Analysts Society of Chicago sends prospective speakers a pamphlet which advises them "to skip the recent history of the company . . . and stress instead such things as new products, capital spending pro-

14. Knowledge of a "push" should be considered knowledge of inside information. See page 222 infra.
15. SPECIAL STUDY, supra note 9, at 87.
17. These analyst groups may be large, such as the 2800-member New York Society of Security Analysts, or small, such as the societies which are limited to analysts who are only concerned with one industry.
18. SPECIAL STUDY, supra note 9, at 83-85. This is, then, another function of the public relations firm.
20. Id.
jections and production rates."\textsuperscript{21} The New York Society of Security Analysts has a similar procedure, but in case its advice is not followed the question-and-answer period is relied upon to evoke the important information. Toward this end, the society arranges for analysts specializing in the industry under discussion to sit at the head table.

The news services are present at some analyst meetings. To the extent that they simultaneously report to the public all of the speaker's statements there is no danger of inside information being disclosed to a limited number of persons. As reported above, there were approximately 5,500 analyst meetings in 1965, and at many of these, especially the meetings held by small analyst groups, there was no press coverage. This can result when the news media are invited but do not choose to attend, when they are not invited, or when they are actually prohibited from attending. Meetings of analysts in Boston usually prohibit the presence of news reporters.\textsuperscript{22} The effect of all this is evidenced in the following observation: "Some [business] concerns charge that some brokerage houses try to hoard the information their analysts get [at meetings], rather than give it the wide distribution many companies believe it should get."\textsuperscript{23}

II. The Problem: Its Framework

It is useful to classify the abuse of inside information in the following way:

1. Transactions by "true" insiders;
2. Transactions by persons who are first-hand recipients of inside information, but who are not "true" insiders;
3. Transactions by persons who are second-hand recipients of inside information.

Section 16 of the Securities Exchange Act\textsuperscript{24} denotes those persons who might popularly be called "true" insiders: essentially officers, directors, and major stockholders. These individuals must file a report each month with the Securities and Exchange Commission stating the securities owned in the "issuer" with which they are connected and the changes in ownership that have taken place in that month. Under subsection (b) of Section 16:

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 ex-

\begin{footnotes}
\item[21] Id.
\item[22] Id.
\item[23] Wall Street Journal, \textit{supra} note 16.
\end{footnotes}
emptied 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.25

This section is a rather frequently referred to example of a rule-of-thumb solution to what otherwise would be a difficult enforcement problem if done on a case-by-case basis. The effect of the section is to create an irrebuttable presumption that when short swing profits result to "true" insiders, the transactions were made on the basis of inside information. As will be emphasized later, the difficult problem that this section avoids is the necessity of proving that the information was "material"; such proof is required for recovery under the general fraud provisions of the Securities Exchange Act. Although abandonment of the necessity of showing intent would appear to be a major point of Section 16(b), intent to defraud has not been a stumbling block in actions under the general anti-fraud provision of the Exchange Act.26

Section 16 has its limitations in that it does not completely cover the field of abuses of inside information by true insiders. Long-swing profits, i.e., profits on purchases and sales, or sales and purchases, resulting from transactions more than six months apart, do not automatically inure to the corporation. However, the general fraud provisions of the Securities Exchange Act, Section 10(b) and Rule 10b-5

   It would defeat the manifest purpose of the Investment Advisors Act of 1940 for us to hold, therefore, that Congress, in empowering the courts to enjoin any practice which operates "as a fraud or deceit," intended to require proof of intent to injure and actual injury to clients. (375 U.S. at 192, 84 S. Ct. at 283). Congress intended the Investment Advisors Act of 1940 to be construed like other securities legislation "enacted for the purpose of avoiding frauds," not technically and restrictively, but flexibly to effectuate its remedial purposes. (375 U.S. at 195, 84 S. Ct. at 284). (Emphasis supplied).
S.E.C. v. Texas Gulf Sulphur, 258 F. Supp. 262, 277 (S.D.N.Y. 1966). The court then said: "Since there is a direct parallel between the language of Rule 10b-5(3) and Section 206 of the Investment Advisors Act of 1940, both in wording and in intent, the use of "fraud" in Rule 10b-5(3) cannot be interpreted in its narrow common law sense." Id. at 278.
   The circuit court further emphasized this point when it stated that certain defendants . . . who ordered purchases before the news could be deemed disclosed, claim, nevertheless, that they were justified in doing so because they honestly believed that the news of the strike had become public at the time they placed their orders. However, whether the case before us is treated solely as an SEC enforcement proceeding or as a private action, proof of a specific intent to defraud is unnecessary. In an enforcement proceeding for equitable or prophylactic relief, the common law standard of deceptive conduct has been modified in the interests of broader protection for the investing public so that negligent insider conduct has become unlawful.
in particular, are applicable. Recovery against true insiders for fraud is easier than against others in possession of inside information, since it is not necessary to show that they are insiders. However, the argument has at times been put forward that liability of true insiders for abuse of inside information can only be based upon Section 16(b), or that officers and directors have, and should have, a right to purchase stock in their corporation for long term holding under any circumstances. In dealing with the contention that Section 16(b) precludes the application of the other fraud provisions to true insiders, the district court in Texas Gulf Sulphur said:

A Section 16 action can be brought only by the corporation itself or derivatively by an existing security holder against officers, directors or beneficial owners of ten percent or more of the corporation's listed equity securities. It covers only short-swing profits realized within a six-month period, and any recovery inures to the corporation. Profits are recoverable regardless of any intent to defraud and without proof that they were realized by reason of inside information. In short, Section 16 was enacted as a "crude rule of thumb" to make unprofitable all short-swing speculation by a specifically defined group of insiders. See, Blau v. Lamb, 363 F. 2d 507 (2d Cir., 1966).

A Section 10(b) action, on the other hand, may be brought pursuant to Section 27 by the Commission or by any party claiming to have been defrauded. The section applies "to any person," not merely to the persons encompassed by Section 16. . . .

The argument that officers and directors should have unlimited rights to purchase stock in their company has been of interest lately because of a book in its defense by Professor Henry Manne. The circuit court in Texas Gulf Sulphur expressly rejects this contention:

Our decision to expand the limited protection afforded outside investors by the trial court's narrow definition of materiality is not

27. 15 U.S.C. § 78j(b) (1964); 17 C.F.R. § 240.10b-5 (1967): 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,

28. Although Rule 10b-5 literally applies to "any person," it has been interpreted to apply only to so-called "insiders." See note 32 infra and accompanying text.


at all shaken by fears that the elimination of insider trading benefits will deplete the ranks of capable corporate managers by taking away an incentive to accept such employment. Such benefits, in essence, are forms of secret corporate compensation, see Cary, Corporate Standards and Legal Rules, 50 Calif. L. Rev. 408, 409-10 (1962), derived at the expense of the uninformed investing public and not at the expense of the corporation which receives the sole benefit from insider incentives. Moreover, adequate incentives for corporate officers may be provided by properly administered stock options and employee purchase plans of which there are many in existence. In any event, the normal motivation induced by stock ownership, i.e., the identification of an individual with corporate progress, is ill-promoted by condoning the sort of speculative insider activity which occurred here; for example, some of the corporation's stock was sold at market in order to purchase short-term calls upon that stock, calls which would never be exercised to increase a stockholder equity in TGS unless the market price of that stock rose sharply.\(^\text{31}\)

The second category of abuse of inside information — transactions by persons who are first hand recipients of inside information, but who are not true insiders — seems to be at the heart of the Texas Gulf Sulphur litigation. A typical case is the one present in Texas Gulf, where a geologist, who was one of the first persons to realize the extent of an ore discovery by the company for which he was working, purchased shares of the company before the public disclosure of the find. The analysis by District Judge Bonsal, in the Texas Gulf Sulphur case, of whether the anti-fraud provisions of the Securities Exchange Act reach the geologist, and what must be proved for a finding of culpability, is basically this:

1. In an action charging a violation of Rule 10b-5 it is not necessary to establish all the elements of common law fraud, such as misrepresentation or nondisclosure, materiality, scienter, intent to deceive, reliance, and causation.\(^\text{32}\)

2. It is especially unnecessary to prove an intent to deceive or injure.\(^\text{33}\)

3. All that must be shown to find a violation of Rule 10b-5(3) is that a purchase was made by an insider based upon material, undisclosed information.\(^\text{34}\)

\(^{31}\) S.E.C. v. Texas Gulf Sulphur, CCH Fed. Sec. L. Rep. ¶ 92,251, at 97,180 (2d Cir. 1968). The district court commented that “. . . it is important under our free enterprise system that insiders, including directors, officers, and employees, be encouraged to own securities of their company. The incentive that comes with stock ownership benefits both the company and its stockholders.” S.E.C. v. Texas Gulf Sulphur, 258 F. Supp. 262, 278 (S.D.N.Y. 1966). This statement, however, is used only to make the point that the inside information must be material for Section 10(b) and Rule 10b-5 to prohibit the purchase of shares.


\(^{33}\) See note 26 supra and accompanying text.

4. As to what constitutes an insider, since Section 10(b) and Rule 10b-5 apply to "any person," all persons with undisclosed and material information could be included; surely employees who are in possession of such information obtained in the course of their employment are insiders.35

5. It is no excuse that the purchase was made on a securities exchange rather than in a face-to-face transaction so that it was impossible to seek out the other party in order to disclose the material information. The answer to such a dilemma is that the insider must "forego the transaction."36

This analysis rather assuredly places an employee, in possession of material, undisclosed information, within the rubric of "insider." The more difficult question, and the one of primary concern here, is raised by the third category of abuse of inside information. The examples of abuse noted in the Introduction to this article are of that kind: transactions by persons who are second-hand recipients of "inside" information, and particularly, information privately disclosed by corporate managers. Since what is involved is a flow of information, there are two roles involved. The "tipper"37 of information, although not directly profiting from a stock transaction, makes it possible for another person, the "tippee," to benefit directly by transacting in shares on the basis of the undisclosed information. Of course, the tippee can change his role to that of a tipper by passing the information on to another party who then takes advantage of it, thus creating a second link in the private flow of information. The concern should probably only be with the first communicative link; that from corporate manager to his "tippee."38

Although all three categories of abuse produce the same result, a "defrauded" stockholder, there seems to be a greater reluctance to apply the fraud provisions of the securities acts to the tipper-tippee situation. Generally, this is because neither party is at the same time a recognized fiduciary of the corporation, or a person connected by way of employment, and the person benefiting directly from the abuse. There is also greater difficulty in uncovering this abuse. The corporate manager must be shown both to have been privy to inside information, which is also requisite in the first two categories, and to have abused the information by way of private disclosure. This is not as easy to detect or prove as an "untimely" transaction in the company's stock. The overt act of purchasing is committed by the tippee, but he is at most only tangentially connected with the corporation whose information is being privately disclosed.39 He has no part in the events

35. Id. at 278-79.
36. Id. at 279. See also note 62 infra and accompanying text.
37. Professor Loss appears to have coined the phrase "tippee," and common parlance has followed the lead by referring to the conveyor of the information as the "tipper." Loss' use of "tippee": 3 L. Loss, SECURITIES REGULATION 1451 et seq. (2d ed. 1961).
38. See pp. 217-20 infra.
39. Use of the word "purchasing" would appear to limit the discussion to bullish news, but it is not intended to do so. Substantively the only difference between
which have given rise to the inside information and is, of course, anonymous to the Securities and Exchange Commission as far as the 16(a) reporting requirements of the corporation are concerned. It is for these reasons that such leaks have seldom been uncovered; perhaps this is why it is unclear in what circumstances and to what degree the law holds the participants culpable.

It would seem that the tippee has committed an unlawful act under Rule 10b-5 when he uses material, undisclosed information "... in connection with the purchase or sale of any security ..." because that constitutes an "... act [or practice or course of business] which operates or would operate as a fraud or deceit ..." upon the other party to the transaction. The only contention put forward to the contrary seems a bit fatuous: that 10b-5 only applies to certain persons called "insiders," even though it literally states that it applies to "any person". The district court in Texas Gulf Sulphur parrots the latest case law statements to the effect that any person with inside information is an insider, but unfortunately those cases deal with first-hand recipients of information, and not with tipper-tippee relationships. This decision reaffirms the position taken by the Commission in an administrative hearing involving a tipping of information; the obligation to disclose material information exists if there is:

... 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 benefit of anyone, and second, [an] ... inherent unfairness involved where a party takes advantage of such information knowing that it is unavailable to those with whom he is dealing.41

The circuit court's opinion contains a similiar statement:

The essence of the Rule [10b-5] 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 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. Matter of Cady Roberts & Co., 40 S.E.C. 907, 912 (1961). Insiders, as directors or management officers are, of course, by this Rule, precluded from so unfairly dealing, 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. Cady, Roberts, supra. Thus anyone in possession of

bullish and bearish news is that no fiduciary relationship is breached when the latter is involved because the corporate manager is causing a sale to one who is not a stockholder. This would have prevented a common law fraud action but does not seem to affect actions under the Securities Exchange Act.


material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.42

Therefore, the Texas Gulf Sulphur opinions are noteworthy as to the liability of tippees only to the extent that the statements about the breadth of the class of persons known as insiders can be said to apply not only to first-hand recipients of inside information, but to second-hand recipients as well. The clearest statement of the culpability of tippees was made by the appellate court, although it is admittedly only dictum:

As Darke's [a defendant] "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.43

The circuit court did establish the culpability of tippers. Although the district court held that "... no violations of Section 10(b) or Rule 10b-5 have been found as to those defendants who recommended TGS stock to others ...",44 application of a different standard of materiality led the appellate court to reach the opposite conclusion: "Darke [a defendant] violated Rule 10b-5 (3) and Section 10(b) by 'tipping' and we remand ... for a determination of the appropriate remedy."45 This statement concedes that tippers fall within the unlawfulness contemplated by Rule 10b-5, but there is uncertainty as to whether they are subject to private rights of action. Perhaps this is because the Commission sought the recovery rather than the selling shareholders themselves. Underlying the court's holding is a conclusion that the so-called privity problem46 raised by the language of Section

43. Id. at 97,181 (emphasis supplied). The issue of tippee liability for transactions based on privately disclosed information has been specifically raised by the S.E.C.'s recent filing of administrative proceedings against Merrill, Lynch, Pierce, Fenner and Smith, Inc. and certain of its institutional investors. See Wall Street Journal, Aug. 28, 1968, at 3, col. 1.
44. S.E.C. v. Texas Gulf Sulphur, 258 F. Supp. 262, 290 n.13 (S.D.N.Y. 1966). The court continued: "[I]t is not necessary to consider whether an insider who violates the Statute or the Rule may be liable for purchases made by his 'tippees.'"
46. This problem was discussed by Judge Bonsal in New Park Mining Company v. Cranmer, 225 F. Supp. 261, 266 (S.D.N.Y. 1963): "A purchaser or seller of stock is not limited under Section 10(b) and Rule 10b-5 to an action against the other party to the purchase or sale; he can sue a third person if in connection with the purchase or sale that person defrauded him." The variety of fact situations that can give rise to an interpretation of the language in 10b-5 "... in connection with the purchase or sale ..." make this statement overly simplistic. Perhaps the best statement of the privity requirement was made in dictum by Judge Herlands, also of the District Court for the Southern District of New York:

Privity of contract between the plaintiffs and the defendants is not a fixed condition precedent to the implication of a private remedy for a statutory violation
10(b) and Rule 10b-5 "... in connection with the purchase or sale ..." is not a stumbling block in finding a tipper's act to be unlawful. The appellate court analyzed these words with great thoroughness when discussing the unlawfulness attendant to the issuing by Texas Gulf of a press release which underplayed the results of the ore find. The release was found by the court to be misleading and it was held that the privity problem was not a bar to relief:

Thus, the legislative history of Section 10(b) does not support the proposition urged upon us by Texas Gulf Sulphur that Congress intended the limited construction of the "in connection with" phrase applied by the trial court. Moreover, comparisons of Section 10(b) with the antifraud provisions of the Securities Act of 1933 ... and with the 1936 antifraud amendment of Section 15 of the Securities Exchange Act of 1934 ... demonstrate that when Congress intended that there be a participation in a securities transaction as a prerequisite of a violation, it knew how to make that intention clear.47

Although the privity question was discussed at length at that point, and in fact placed in a separate subsection, the court found it unnecessary to even mention it when discussing tipper culpability.

As will be seen later in this article, the liability of tippees is of little concern in ending the prevalence of flows of inside information; it is the tippers, the corporate managers, to whom our attention should be directed. Although the availability of a private right of action against tippers is a solution which may be unworkable, the important thing is the recognition that tippers are culpable and, more specifically, that their actions are unlawful under Rule 10b-5 and can be further regulated under the rule making power of Section 10(b).

III. The Crux of the Problem: Materiality

The Texas Gulf Sulphur litigation involves information concerning a discovery of ore near Timmins, Ontario, Canada. According to the findings of the district court,48 the area was first thought to have promise by the members of a Texas Gulf exploration group in 1959. In the early summer of 1963, options on part of the area were

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purchased and on November 8 of that year the drilling of test holes began. From November 12, the day when preliminary drilling of the first hole was completed, visual estimates of its ore content were made, and attempts to secure further acquisitions in the area under consideration were undertaken, insiders began to make large purchases of Texas Gulf stock.\textsuperscript{49} Insider purchases and the tipping of information continued, as the drilling proceeded, until a public announcement of the ore find was made on April 16, 1964. Some of the defendants in the litigation had knowledge of the results of the drilling from the very beginning, while others came into the picture only when they learned of the results in the news release prior to its dissemination to the public. Some merely purchased stock, some only advised others to do so, and a few did both.

These facts have given rise to private suits against some of the defendants in Texas Gulf Sulphur based upon the failure to disseminate the information to the public earlier than April 16, 1964.\textsuperscript{60} It has been contended that management has the duty to disseminate material information as it becomes available so that stockholders will not sell their stock at a price which is based upon knowledge of the company that does not include this new information.\textsuperscript{51} Although the circuit court was only presented with the question of allegedly misleading statements, the tone of its opinion may bode well for such an argument. At the beginning of its discussion of the “in connection with the purchase or sale” language of 10b-5, the court quotes from a House Committee report on the bill which ultimately became the Securities Exchange Act of 1934:

The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of information obstructs the operation of the markets as indices of real value. \textit{There cannot be honest markets without honest publicity}... The disclosure of information materially important to investors may not instantaneously be reflected in market value, but despite the intricacies of security values truth does find relatively quick acceptance on the market.\textsuperscript{52}

\begin{itemize}
\item \textsuperscript{49} See S.E.C. v. Texas Gulf Sulphur, CCH Fed. Sec. L. Rep. \textsuperscript{\$} 92,251, at 97,174 (2d Cir. 1968).
\item During this period, from November 12, 1963 when [drilling of the first preliminary test hole] was completed, to March 31, 1964 when drilling was resumed, certain of the individual defendants...[and their tippees] purchased TGS stock or calls thereon. Prior to these transactions these persons had owned 1135 shares of TGS stock and possessed no calls; thereafter they owned a total of 8235 shares and possessed 12,300 calls.
\item The same contention applies to the withholding of bearish news, which if known by the shareholder might have prompted his sale of shares.
\item S.E.C. v. Texas Gulf Sulphur, CCH Fed. Sec. L. Rep. \textsuperscript{\$} 92,251, at 97,186 (2d Cir. 1968).
\end{itemize}
Later in the opinion the court also observed:

[I]t seems clear from the broad legislative purpose Congress expressed in the Act, and the legislative history of Section 10(b) that Congress when it used the phrase "in connection with the purchase or sale of any security" intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities. 53

In the absence, however, of an express holding that management must make public any available material information, the stock exchanges have placed this obligation on listed companies by directing them to disseminate all such information. 54 Regardless of the route to such complete dissemination, a determination of the point at which information becomes material must be reached.

The suit by the Commission against the Texas Gulf defendants also involves a determination of when the information became material; but this determination involves considerations of materiality different from those involved in private suits. The duty to disseminate material information to the public raises a problem if the news is not so certain and definite as to be capable of presentation in a way that will not mislead persons into giving it more certainty or definiteness than is warranted. Also, it may be in the corporation's interest to withhold the information. Such was the case in the Texas Gulf Sulphur explorations, because the corporation wanted to buy adjoining land at a price that would not reflect the possible existence of ore. 55 In either situation management could be subject to liability for premature disclosures. On the other hand, the duty placed on persons with material inside information not to purchase stock or tip the information without making sure that it is information which is available to the other party to the transaction, does not present these conflicting considerations of stockholder protection, nor does it result from any normal corporate obligation. This duty only arises in conjunction with the "right" to purchase stock in a company one is working for, and, as indicated by Texas Gulf Sulphur, this right does not exist if the material information cannot be disclosed. Furthermore, there is surely an even stronger case for requiring a corporate manager to forego a disclosure than to forego a transaction. The important point to recognize is that there are at first two distinct situations in which the question of materiality can arise. In metaphorical terms, management is not dealing with a two-sided coin with one side dictating public dissemination and the

53. Id. at 97,187 (emphasis supplied).
54. See notes 82-84 infra and accompanying text.
55. Generally, a purchaser of land is not considered to have acted fraudulently if he fails to disclose information to the seller concerning natural resources that lie in the seller's land. There is no hypocrisy in arguing for that rule of law and at the same time advocating full disclosure in stock transactions. The former has a strong economic justification in that it encourages the seeking out of our natural resources. Some economic justification can be attributed to insider trading, but not to insider tipping. See note 30 supra and accompanying text.
other permitting any limited disclosure management wishes. Instead there is a middle area in which corporate news must be kept within the company.

Judge Moore, dissenting from the majority in the Second Circuit, failed to recognize this middle area. He posed a hypothetical press release dated November, 1963 which he said the majority "implicitly suggested": "TGS as a result of drilling on its property in Canada has knowledge of the more than marginal possibility of a mine of magnitude over an extensive region of remarkably rich mineralization." This he categorizes as ". . . a statement which under the circumstances and then known facts would have been the height of recklessness." Judge Moore continued:

In fact, the Commission itself indulges in the very speculation it condemns for, after conceding that "the trial court correctly stated that one drill hole does not establish the existence of a commercially minable mineral deposit", it straightway contends that the information which arose after the drilling of this first and only (for 4½ months) drill hole revealed such "chances of imminent success, viewed in the light of the magnitude of the potential economic benefit to Texas Gulf" as to require disclosure by insiders desiring to buy TGS securities. While Judge Moore conceded that the information was not certain or definite enough for public dissemination, he disregarded the majority's admonition to the effect that if a person in possession of material inside information is "disabled from disclosing it" or "chooses not to do so" he "must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed." The majority did not suggest that public dissemination should have been made in November, 1963, nor did it allow private use of the information. Instead it correctly required insiders to forego all transactions or tips based on the information until such time as an announcement could properly be made:

We do not suggest that material facts must be disclosed immediately; the timing of disclosure is a matter for the business judgment of the corporate officers entrusted with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and by the SEC. Here, a valuable corporate purpose was served by delaying the publication of the K-55-1 discovery. We do intend to convey, however, that where a corporate purpose is thus served by withholding the news of a

57. Id.
58. Id.
60. Id.
61. Id.
material fact, those persons who are thus quite properly true to their corporate trust must not during the period of non-disclosure deal personally in the corporation's securities or give to outsiders confidential information not generally available to all the corporations' stockholders and to the public at large.  

What then is the present meaning of materiality in the context of insider trading and particularly in the case of tipper-tippee relationships? To thoroughly understand the circuit court's definition in *Texas Gulf Sulphur*, it is useful at the outset to examine earlier, more general statements by courts, members of the Commission, and commentators. William Cary, past chairman of the Securities and Exchange Commission, was asked in connection with the suit against *Texas Gulf Sulphur*: "Under what circumstances and when may the managements trade?" He replied:

[I]n this connection, what type of information must be released? Here in essence we are trying to define materiality. It is very difficult at best. We have had three cases thus far; a dividend cut, a significant ore strike (characterized as one of the most important finds in modern times), and the *Golconda* case, a merger—all extreme situations. I recognize that lines must be drawn on the conservative side, when for example a company is in the process of the negotiation of a merger. I think it is safe to say that information should be disclosed when, if known, it would have a significant effect on the market price of the stock.  

The dividend cut case described by Professor Cary is the administrative proceeding against Cady, Roberts and Company, and the significant ore strike refers to the *Texas Gulf Sulphur* litigation. Professor Cary was speaking after the filing of the complaint in the *Texas Gulf Sulphur* case but prior to the district court's decision. The trial court went into great detail about the mining operations in evaluating the knowledge held by the defendants at various stages of the explorations. It must have been as great a surprise to Professor Cary as it was to this writer that the court concluded that material information was in existence only near the very end of the explorations. The correctness of the conclusion that results of the explorations from November to April 9 did not constitute information which could be considered material involves, in part, an analysis of mining which few persons are qualified

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62. Id. at 97,179 n.12. The requirement of foregoing a transaction, or the later development of foregoing a tip has its roots in common law security fraud actions. In 1903 the court in *Oliver v. Oliver*, 118 Ga. 362, 45 S.E. 232, 234 (1903) stated: It might be that the director was in possession of information which his duty to the company required him to keep secret; and, if so, he must not disclose the fact even to the shareholder, for his obligation to the company overrides that to an individual holder of the stock. But if the fact so known to the director cannot be published, it does not follow that he may use it to his own advantage, and to the disadvantage of one whom he also represents. The very fact that he cannot disclose prevents him from dealing with one who does not know, and to whom material information cannot be made known.  


to undertake. What is the significance as to materiality of the finding that "... one drill core does not establish an ore body, much less a mine," and what can be gleaned about materiality for future mining situations when the court's conclusions as to the other drilling cores are not verbalized even to that extent?

In addition to the specialized analysis of mining, Judge Bonsal made some general statements about materiality:

Material information has been defined as information "which in reasonable and objective contemplation might affect the value of the corporation's stock or securities * * *." [Citations omitted]. It is information which, if known, would clearly affect "investment judgment," Cady, Roberts [40 S.E.C.], at 911, or which directly bears on the intrinsic value of a company's stock.

This definition is not unlike that of Commissioner Budge, which focuses on "... whether the information is important enough that it would normally influence the judgment of the other party in a securities transaction," or whether "the information could be expected to have a significant effect on the price of the stock if it were disclosed." There have been further attempts by commentators to define materiality, all of which basically toy with these concepts of "reasonable" or "normally"; "affect" or "influence"; "directly bears on" or "significantly affects" and "intrinsic value" or "price." To point out the vagueness of these terms, and of the definitions of which they are a part, might provoke the answer that the words and definitions will take on meaning on a case-by-case basis and that this is not the first instance of elasticity in legal formulation. There is perhaps a greater problem in the use of such words than mere vagueness: that of irredeemable and misleading meaninglessness.

The latest definition, enunciated by Judge Waterman, speaking for the Second Circuit in Texas Gulf Sulphur, attempts to avoid the use of such ambiguous terms: "Thus, material facts include not only information disclosing the earnings and distributions of a company, but also those facts which affect the desire of investors to buy, sell, or hold the company's securities." This very broad and flexible formulation will nevertheless require further definition and refinement to ascertain its exact boundaries. What information is there which, if known by one party, would not affect an investor's attitude toward a particular security? As a general matter the price of a stock reflects a general consensus, arrived at rationally or otherwise, as to the appropriate rate of capitalization of a predicted stream of future earnings.

66. Id. at 280.
67. Suggestions as to a test of materiality by Hamer H. Budge, Member of the Securities and Exchange Commission, in an address to the New York Chapter of the American Society of Corporate Secretaries on November 18, 1965. A copy of the address is available from the S.E.C.'s Washington, D.C., office.
The capitalization rate and predicted earnings are in turn based upon facts about the company, the industry of which the company is a part, and the economy as a whole. An increase in the quantum of bullish facts should have an upward effect on the price of the stock. A fact does not have to have a high degree of certainty or definiteness in order to be of value. A mere 10% certainty of a 10 million dollar ore find should lead an investor to calculate a probable effect of 1 million dollars on the value of the company,\(^70\) which can then be divided by the number of shares outstanding to arrive at the probable effect on the price of each share. Similarly, a 10% chance of a gain which is indefinite in amount, but between 5 and 10 million dollars, can be said to have a probable effect of at least 500,000 dollars on the value of the corporation.

The district court in *Texas Gulf Sulphur* articulated another aspect of this arithmetical approach to materiality. It emphasized the relationship between the predicted dollar value of the information and the total dollar value of the company. Judge Bonsal stated:

> However, the drilling results up to 7:00 p.m. on April 9 did not provide such material information. When considered in relation to the far-flung business of TGS at the time, it cannot be said that the drilling results of K-55-1 and K-55-3 constituted material information, the disclosure of which would have had a substantial impact on the market price of TGS's 10,000,000 outstanding shares.\(^71\)

The circuit court apparently incorporated both of these concepts; Judge Waterman stated that:

> In each case . . . whether facts are material within Rule 10b-5 when the facts relate to a particular event and are undisclosed by those persons who are knowledgeable thereof will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.\(^72\)

It might be said that such calculations are based upon figures which have as little certainty as the definitions of materiality. This is a problem which faces management when they must decide if news of corporate developments is so certain and definite — so material, as to warrant and require dissemination to the public. In the case of insider trading or tipping, questions about the accuracy of the calculations

\(^{70}\) This example is offered for its theoretical substance rather than the financial propriety of its calculations. The approach taken would be considered a book value computation which in the appraisal of stock values will often be included in the mix of calculations in which a prediction of future earnings will have a predominant role. This seems more appropriate than to include ten million dollars in the future earnings stream because it is a revenue arising on one occasion and not a recurring source of revenue.


can be avoided by simply foregoing the transaction or foregoing the tip.\textsuperscript{73}

In making a determination of materiality it is very tempting to consider the value of the information in question in light of the facts as they subsequently appear, rather than as of the time the determination is made. In the \textit{Texas Gulf Sulphur} situation, a large ore discovery was indeed made, and large amounts of trading and tipping by insiders took place during the period in question. In dealing with these two developments, the district court stated: "the fact that subsequent drilling established a major ore body is immaterial... 'the court must be guided not by hindsight, but by the facts as they existed at the time of the challenged transaction'"\textsuperscript{74} and:

The Commission contends, however, that the results of K-55-1 were material because of the significance attached to those results by certain defendants. Between the completion of K-55-1 on Nov. 12, 1963 and the completion of K-55-3 on April 7, 1964, [certain defendants] spent more than $100,000 in purchasing stock and calls on the stock of TGS. These defendants could bring considerable expertise to bear in evaluating the results of K-55-1 and their purchases may have been prompted by an educated guess that K-55-1 would lead to the discovery of a mine. Therefore, a question is presented as to whether information which may have special significance to an insider because of his professional background, is material.

A similar question would be presented where an engineer in the research department of a publicly-held corporation believes that he may have invented a process which will substantially increase the corporation's earnings or where a chemist in a large pharmaceutical firm thinks that he may have devised a chemical formula which can cure cancer. In these instances it can be assumed that the insider, because of his educated guess, will be enthusiastic and his enthusiasm may lead him to purchase stock in his company and to recommend the stock to his associates and friends even though his educated guess may turn out to be wrong. It may be argued that such purchases are "unfair" to the outside stockholders and come within the ambit of Section 10(b) and Rule 10b-5. Purchases on the basis of educated guesses may be viewed as an attempt to secure additional corporate compensation. Cary, "Corporate Standards and Legal Rules," 50 Calif. L. Rev. 408 (1962).

\textsuperscript{73} The implications of this approach to materiality are not entirely clear. In addition to the difficulties attendant to making such a determination, a balancing test of this nature could encourage a further extension to an investigation of the significance of the impact on each shareholder who enters into a transaction without the benefit of this additional information. Although such an extension appears unlikely at this time, it is not entirely inconsistent with the attitude exhibited by either of the \textit{Texas Gulf Sulphur} courts.

However, most insiders necessarily have educated guesses about the prospects of particular company programs. If it is held that purchases made on the basis of educated guesses are proscribed by Section 10(b) and Rule 10b-5, insiders who purchase stock in their company will do so at their peril. If they announce their educated guesses before purchasing and their guesses turn out to be wrong, they would be subject to suit; and if they purchase and keep their educated guesses to themselves and they turn out to be right, they would again be subject to suit. The creation of such a dilemma would result in insiders not buying at all although insiders should be encouraged to have a stake in the companies for which they work.

The outside stockholder can never match the knowledge of an insider who necessarily knows more about the company and is in a better position to evaluate its prospects. It may be that the "fairness" overtones of Cady, Roberts indicate a trend toward the elimination of all insider purchasing. But even were the court prepared to accept the proposition that all insider trading is unfair, a proposition of doubtful validity at best, it would be deterred by the admonition of Judge Learned Hand that it is not "desirable for a lower court to embrace the exhilarating opportunity of anticipating a doctrine which may be in the womb of time, but whose birth is distant. . ." 75

To the extent that the topic of the above is insider trading there is at least some merit to the court's contentions, but this validity does not extend to insider tipping. Such tipping has nothing to do with the stake which corporate managers have in their company, and, therefore, no perilous situation need arise. Educated guesses are valuable information which probably cannot be disseminated to the public, perhaps should not be traded upon, and definitely should not be disclosed to a few persons. To say, as the district court did elsewhere, that "information is not material merely because it would be of interest to the speculator on Bay Street or Wall Street" 76 or that "the test of materiality must necessarily be a conservative one" 77 may be satisfactory for insider trading purposes but not for those of insider tipping. In the latter case, there are no policy considerations to balance against the "unfairness" involved.

Although the circuit court was no more willing to expressly prohibit all insider purchasing than the district court, two of its statements may in many instances accomplish the same thing. 78 Rejecting much of

75. 258 F. Supp. at 283-84.
76. Id. at 280.
77. Id.
78. This statement is not meant to apply to information which in the normal business context would be considered insignificant. This attitude further emphasizes the notion that some information, while not material enough to require dissemination or a prohibition on insider purchases, still should not be tipped.

An insider is not, of course, always foreclosed from investing in his own company merely because he may be more familiar with company operations than are outside investors. An insider's duty to disclose information or his duty to
the trial court's characterization of the nature of materiality, Judge Waterman stated that:

The only regulatory objective is that access to material information be enjoyed equally, but this objective requires nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of insiders.

This is not to suggest, however, as did the trial court, that "the test of materiality must necessarily be a conservative one, particularly since many actions under Section 10(b) are brought on the basis of hindsight," . . . in the sense that the materiality of facts is to be assured solely by measuring the effect the knowledge of the facts would have on prudent or conservative investors. As we stated in List v. Fashion Park, Inc., 340 F. 2d 457, 462, "The basic test of materiality . . . is whether a reasonable man would attach importance . . . in determining his choice of action in the transaction in question," . . . (Emphasis supplied). This, of course, encompasses any fact . . . "which in reasonable and objective contemplation might affect the value of the corporation's stock or securities. . . ." [Citations omitted]. Such a fact is a material fact and must be effectively disclosed to the investing public prior to the commencement of insider trading in the corporation's securities. The speculators and chartists of Wall and Bay Streets are also "reasonable" investors entitled to the same legal protection afforded conservative traders.79

In deciding that the existence of insider activity may be of significant probative force in a subsequent judicial determination of materiality, the circuit court may have placed an intolerable burden on corporate managers who attempt to act in good faith. In effect, the court has said that the value, or materiality, of information can be measured in very large part by the extent of insider trading. Accordingly, even if insiders or others accurately determine that the information at their disposal is not material at a particular point in time and proceed to trade on it, a court, following the language of the Second Circuit, may in fact allow itself to "be guided . . . by hindsight . . .":

Finally, a major factor in determining whether the K-55-1 discovery was a material fact is the importance attached to the drilling results by those who knew about it. In view of other related recent developments favorably affecting TGS, participation by an informed person in a regular stock purchase program, or even sporadic trading by an informed person, might lend only 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."


79. Id.
nominal support to the inference of the materiality of K-55-1 discovery; nevertheless, the timing by those who knew of it of their stock purchases and their purchases of short-term calls — purchases in some cases by persons who had never before purchased calls or even TGS stock — virtually compels the inference that the insiders were influenced by the drilling results. This insider trading activity, which surely constitutes highly pertinent evidence and the only truly objective evidence of the materiality of the K-55-1 discovery, was apparently disregarded by the court below in favor of the testimony of defendant's expert witnesses, all of whom "agreed that one drill core does not establish an ore body, much less a mine."80

The circuit court's definition of materiality, accompanied by its seemingly stringent regulation of insider transactions, appears to apply equally to the problem of tipping. The court does not frame its test in terms of the different policy considerations present for each type of situation. Materiality could perhaps be divided into three categories similar to those classifying the abuse of inside information: the true insider who has a duty to decide what information is so material it must be disseminated to the public; the person buying shares and possessing inside information who must decide whether that information is so immaterial it need not be disclosed to the other party to the transaction; and those persons, especially corporate managers, who must decide if the information is so immaterial it can be disclosed to a few persons.

At the trial Judge Bonsal concluded that none of the tippers was in possession of material inside information; on appeal it was found that they were. Each court applied its test of materiality indiscriminately to trading and tipping, and, while the result on the appellate level may be correct, courts must in the future view materiality distinctively in each context.

IV. PRIVATE ATTEMPTS AT 'REGULATION'

A. The Exchanges and the NASD

The Special Study states: "Federal law is in the main not concerned with 'unofficial' corporate publicity."81 The exchanges seem to have taken a more aggressive role in this delicate area. The New York Stock Exchange requires listed companies to make prompt disclosure of developments "which might affect security values or influence investment decisions of stockholders or the investing public."82 The American Stock Exchange has a similar policy, and the Midwest and Pacific Coast exchanges require prompt disclosure at least to the extent of dividend news. The National Association of Securities Dealers, or NASD, also requires prompt disclosure by over-the-counter listed

80. Id. at 97,180.
81. SPECIAL STUDY, supra note 9, at 93.
82. NEW YORK STOCK EXCHANGE, COMPANY MANUAL, A20-A22.
A recent addition to the *New York Stock Exchange Company Manual* states:

At some point it usually becomes necessary to involve other persons to conduct preliminary studies or assist in other preparations for contemplated transactions, *e.g.*, business appraisals, tentative financing arrangements, attitude of large outside holders, availability of major blocks of stock, engineering studies, market analyses and surveys, etc. Experience has shown that maintaining security at this point is virtually impossible. Accordingly, fairness requires that the Company make an immediate public announcement as soon as confidential disclosures relating to such important matters are made to "outsiders."  

Without disparaging these "prompt disclosure" requirements, it must be realized that they only begin to solve the problem of non-public disclosure. The obvious implication of these rules is that information which must be disseminated to the public immediately cannot be told to a few persons. If the exchange says nothing more, the unfortunate suggestion is that there is no middle area in which public dissemination is not required but in which limited disclosure is prohibited; in metaphorical terms, disclosure becomes a two-sided coin.

A recent publication of the New York Stock Exchange, *The Corporate Director and the Investing Public*, addresses itself to the problem of non-public disclosure. It virtually eliminates any middle area and instead attempts to establish a procedure by which limited disclosures can be made in a fair and evenhanded way. The booklet's section "Timely and Adequate Disclosure of Corporate News" begins by delineating the types of corporate news which must immediately be disseminated to the public. It then states:

Annual reports, quarterly reports, and publicity releases cannot, by their nature, detail all of the operations of the company. Therefore, it is highly desirable that corporations follow a so-called 'open door' policy for the benefit not only of stockholders but also security analysts, financial writers, and others who have legitimate interest in the various factors affecting a company's business.

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. By the same token a company should not withhold information in which stockholders, the investing public, and analysts have a warrantable interest.

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83. *Special Study, supra* note 9, at 99.
85. *This booklet can be obtained free by writing to the New York Stock Exchange, 11 Wall Street, New York, N.Y. 10005.*
To assure that the release of corporate information is handled capably, consistently, and authoritatively, many companies designate one or more key executives to speak for the company in all matters that might affect security values or influence investment decisions. There is much to recommend this procedure.

Normally a director should limit his discussions with outsiders to information which is publicly available or which would not be classified as confidential under company policy. However, there may be rare occasions when a director should speak out publicly on some important matter which management should have disclosed.87

These guidelines are inadequate in several respects. It is unrealistic to think that the small investor will have the same opportunity to walk through the "open door" as financial analysts and writers and friends of management. It is not possible to answer everyone's inquiries, and in the final analysis only friends and "professionals" will be able to speak to management. This is especially true in view of the exchange's suggestion that "one or more key executives" do all the speaking. Even assuming the implementation of an "open door" policy, giving information to all callers is, nevertheless, impractical. When information is disseminated through the news services, these problems largely disappear.

These objections are compounded by the fact that the exchange has set a meaningless standard for limiting disclosure of the information which is not immediately distributed to the public. Outsiders are only to receive information "which is publicly available" or "which would not be classified as confidential under company policy." The first clause could not have been meant to set the standard because the exchange states that the news in the public sphere is not sufficient. The second clause seems to state the standard as one of non-confidential information in a protection-of-company sense. This does not further our body of "regulation" because directors are already under that duty to the corporation.

It should be noted that the exchange has taken effective steps to reduce the extent of leaks of "inside" information. The Corporate Director booklet states: "The market action of a company's security should be closely watched at these times [when significant corporate deliberations are taking place] and the company should be prepared to make a public announcement of the matter under consideration if this becomes necessary."88 The exchange's stock watching department keeps a close surveillance of market activity and will encourage a listed company to make a public statement if it detects heavy trading on "inside" information. A suspension of trading in the stock may be ordered if time is needed to disseminate the information. Such action by the exchange and listed corporations usually involves corporate news which should have been disclosed to the public. The Studebaker Cor-

87. Id.
88. Id.
poration on February 24, 1966 issued a forecast of its 1966 earnings because the corporation felt that some investors had ascertained the figure. Although a prediction of earnings is a valuable piece of information, a prediction this early in the fiscal year would not be considered, under present-day thinking, to require public disclosure. It is for this reason that the New York Times called the Studebaker announcement an "unusual step."\footnote{89}

Regardless of the extensive use that could be made of the "public statement," it must be remembered that it is only called into play after persons are suspected to have traded on "inside" information. The real cure lies in enforcing a prohibition against the private disclosure. Furthermore, the "public statement" should not become the tail that wags the dog as the following quote from the Special Study seems to indicate: "The exchange [New York Stock Exchange] takes the position that a matter still in the planning or developmental state, such as a prospective merger or new product, should be announced as soon as it appears likely that a sizable number of persons will hear of it."\footnote{90} This approach should be used when it is impossible to enforce a rule prohibiting private disclosures, and not before.

B. 'Self-Regulation' by Corporations

The New York Stock Exchange suggests that companies make periodic reviews of their disclosure policy and internal security practices.\footnote{91} The General Electric Corporation has adopted a disclosure policy which provides that: "... no 'substantive' information can be given out on a limited scale, such as to a security analyst or enterprising reporter trying to develop an exclusive story. By substantive, the company means any kind of information that is significant enough to influence the price of GE's stock."\footnote{92} Although the bounds of "substantive" information are not spelled out in any detail, there is still some value in having a company verbalize such an attitude. Internal security practices at the Coca Cola Company include a requirement that all employees sign a sworn statement to the effect that they will not divulge "inside" information they acquire while at work.\footnote{93} Some firms play an important role in protecting "inside" information after it leaves the confines of a corporation. Printers of corporate financial statements, prospectuses, and other documents containing confidential data usually divide an assignment in such a way that no one employee will be able to grasp the essence of the material.\footnote{94} Many news media have rules to prevent their employees from capitalizing on "inside" information that arises because of "hold-for-release" announcements.\footnote{95}

\footnote{90. Special Study, supra note 9, at 98.}
\footnote{91. New York Stock Exchange, supra note 86, at 6.}
\footnote{92. Wall Street Journal, supra note 6, at 12, col. 3.}
\footnote{93. Id.}
\footnote{94. "Financial Printers Guard Against Wrong Use of Data," Wall Street Journal, April 27, 1965, at 12, col. 4.}
\footnote{95. Wall Street Journal, supra note 7, at 12, col. 3. This article describes an interesting situation in which the Avis Company requested the Dow Jones News}
The practice of making public statements to bring equality to the market place when it becomes apparent that some investors are trading on “inside” information is primarily a tool of the exchanges. It is doubtful that many companies would make such announcements if the threat of a suspension of trading did not exist.

V. PROPOSED SOLUTIONS

A. Ideal Market Operation; Cause and Effect of Imperfections

Persons who engage in business transactions have a desire to act rationally and profitably in those transactions. It is helpful to be able to gather many of the facts necessary in order to make an intelligent decision; it is crucial to have available all the facts obtainable by the other party to the transaction. In stock trading, if there is no inequality in fact availability, profits are reaped only after a high degree of business acumen is applied to the facts. The investor, with the aid of his broker and Wall Street analysts, must compute the price at which the stock should be selling. In the final analysis this entails a prediction of future earnings and a judgment as to the rate of capitalization to be applied. An examination of the role of the computer on Wall Street is helpful in picturing this ideal form of market operation. The computer is equipped with a complex mathematical formula that takes into account dividends, earnings, company growth rates, management quality, risks inherent in the industry, and other factors. After the facts are “fed in,” the function of the computer is to figure the “real value” of the stock and to compare it with the current price. The computer’s calculations are only of value if the facts it receives comprise the totality of information available to other investors.

When one party to a stock transaction is acting on accurate information disclosed to him by a corporate manager, which is not available to the other party to the transaction, the latter investor has been “defrauded.” To the extent that present-day thinking does not reach this conclusion, it is fostering several bad results. Not only has the party on the “wrong” side of the transaction suffered a financial loss because he did not have the right “contacts,” but also he has not received a financial reward for the intelligent use of business acumen that he might deserve. If he is forced to end trading in the market because of further such losses, a potentially high degree of business judgment may go unrewarded. By the same token, the person on the “right” side of the transaction may be a loser in subsequent transactions. He has been encouraged to trade on inside information which, if accepted

Service to postpone publication of its quarterly earnings for one week so that Avis stockholders could receive the information ahead of the public. Dow Jones refused and published the information immediately. This is, in effect, one corporation imposing “self-regulation” upon another corporation.


97. The comprehensiveness of the computer’s procedure does not mean that the human analyst will eventually disappear or will have to justify his existence by obtaining “tips” from corporate managements. Analysts who are working with computers find that there is a great amount of information that the machine cannot take into account, such as the “emotional” factor of market operation and the state of the market as a whole. Id.
in the form of rumor, may be inaccurate. On a different level it can truly be said that society loses when business transactions are conducted on such an unsophisticated level. When “what you know” is determined by “whom you know,” the business community is reduced to a non-professional status.

The problems are increased when one realizes that private disclosures of information by management do not always reach investors directly. News tends to become distorted when it passes through many people, even if it is accurate in its first communication. This is the phenomenon of the Wall Street rumor. It owes its existence to the fact that tips of inside information have been prevalent and, at times, accurate. The New York Stock Exchange suggests that:

 Occasionally, it may be necessary for corporate officials to deny false rumors or clarify misunderstandings which are affecting the market in their company’s stock. A quick, clear announcement to the press and wire services along with immediate notice to the Exchange is the most effective procedure under these circumstances.

This does not cure the harmful results that have occurred before the public statement is made. The investor who has relied on a rumor may have traded stock on exaggerated information. If the rumor is accurate in part, the investor who does not hear of it, or who does not believe in relying upon rumors, may be entering into transactions with persons who, to some degree, have inside information. Furthermore, a vast group of non-investors may be harmed when stock prices are based on inaccurate information. Business deals, such as some corporate mergers, that draw on the price of publicly traded shares rely upon stocks being accurately valued.

Two basic reasons can be suggested for the seeming propensity of corporate managers to divulge “inside” information to particular individuals. The first concerns corporate news which is not so certain in fact to permit disclosure to the public. As was stated in Goodwin v. Agassiz: “Disclosure of the theory [that copper deposits might exist], if it ultimately was proved to be erroneous or without foundation in fact, might involve the defendants [officers of the corporation owning the property] in litigation with those who might act on the hypothesis

98. The net result can be a loss of liquidity in the market place to the extent that traders who are scared away because of a lack of “contacts” are not replaced by traders with “contacts.”

99. The New York Times recently reported:
Manuel F. Cohen, chairman of the Securities and Exchange Commission, warned yesterday that public confidence in the fairness of securities markets could be undermined by improper use of inside information.

“That confidence, so necessary to the continued healthy growth of our markets, cannot be preserved if there is a belief — indeed a suspicion — that insiders are taking advantage of information gained by virtue of their relationship to the company or possession of privileged information, even if the insiders are complying with the letter of all the technical guidelines that the ingenuity of the commission can devise,” the chairman said.


100. NEW YORK STOCK EXCHANGE, supra note 86, at 6.
that it was correct."101 Such information might be sufficiently valuable that persons with knowledge of it, as in Goodwin, will buy the corporation’s stock. The increased demand will raise the price of the stock; this can be advantageous to management. Directors and officers who own shares in the corporation will be able to sell at a higher price,102 and their chances of retaining their office or seat on the board of directors will be greater. These factors are perhaps only important in the short-run; in the final analysis all of the information about a company will be available to all persons and the company’s stock will have its appropriate price. However, to many corporate managers it is the present that counts, and the disclosure of news that is not yet “ripe” for public announcement may produce a larger profit on the sale of stock and extended tenure with the corporation.

The second reason for management’s disclosures of inside information to a few persons is not dependent on any “immaterial” or “bullish” character of the news. The explanation is friendship. Tippees often profit from the information they have received. If the news is “bullish,” stock can be purchased before its price goes up; if it is “bearish,” a tippee can sell shares he owns or sell short before the news reaches the market. The tipper will probably receive a financial reward for his services. In any event, he has created or fostered a “friendship” which may prove to be valuable in the future.103

B. A Solution

There are, then, two recipients of the harm caused by the flow of inside information: the individuals who are on the “wrong” side of the transaction, and the market place as a whole. A scheme of reform must consider both. “Defrauded” investors must be compensated and tippers must be deterred.

To the extent that money damages act as a deterrent, both objectives could be obtained by recognizing a broad liability of tippers to the injured stockholders. This liability could be very great, especially if tippees were held responsible for transactions by remote tippees who did not receive the information directly from the original tipper. It seems much fairer and more appropriate, however, to hold tippees liable to the injured parties. This would have a deterring effect on the solicitation of private disclosures; in order to effectively cut off private flows, however, the original tippers, corporate managers, must be held

102. The profit may be kept only if the transaction is outside the six-month period of Section 16(b) of the Securities Exchange Act.
103. Some friendships exist that do not depend on financial incentives. An unusual example of this came to the attention of this writer not long ago. It involved the disclosure by a corporation to various mutual funds holding shares of the corporation that a poor earnings record was to be announced shortly. It is possible that the motive for the “tip” was the expectation that the mutual funds would be more likely to purchase the corporation’s shares in the future if they could be apprised of unfavorable news ahead of the market. However, some persons who were familiar with the management of the corporation suggested that the disclosure was made because the officers, almost all of whom are of “humble origins,” were overwhelmed by the possibility of aiding the prestigious members of the boards of directors of the mutual funds.
The question then is under what circumstances or for divulging what information should a tipper's conduct be subject to criminal penalty? In light of the abuses described in the preceding sections, it might be suggested that all communications between corporate managers and a limited number of persons be absolutely prohibited. All corporate news emanating from the confines of management would reach the public through the news services. This solution removes the difficult task of determining what information is sufficiently "immaterial" to permit disclosure by management to a few persons. As pointed out earlier, the required proof of materiality can still be a stumbling block in holding a tipper culpable although almost all information can be viewed as having an influence on an investor's judgment. Also, to the extent that materiality should have any meaning in tipping situations, that meaning should be more inclusive than the standard used for the permissibility of insider trading, and much more inclusive than the standard used to decide whether information is so material that it must be disseminated to the public. This solution also reflects a justifiable skepticism of the theory that no one is harmed by limited disclosures because the information eventually filters down to all who want it. Such complete dissemination is achieved through rumor, which has a tendency to distort the information and to communicate it to persons at different times.

Regardless of the value of such a neat rule, it must be rejected. In the first place, a prohibition of all limited disclosures would probably be unworkable, whether it took the form of Commission rule, exchange rule, or court doctrine. The problems of enforcement would be too great. Furthermore, the legal process caveat that rules which are unenforceable breed a general disrespect for other rules is applicable here. There is something of this in the following quote from an article in the Wall Street Journal on stock "tips": "Rules that try to answer every question and protect every fool always cause more trouble than they cure. There's no need to read dire plots into every luncheon conversation." Secondly, an absolute prohibition does not preserve those limited communications which may be beneficial to the investing community if not done in an abusive way. The news services would be strained if called upon to disseminate the information which now

104. See note 44 supra and accompanying text.
107. The best example is the "reasonable basis" rule mentioned on page 192 supra. It is also obvious that no rule that is adopted should interfere with disclosures of information to banks or other organizations such as regulatory agencies where the information is required by law or as a business necessity or convenience.
reaches the market through security analyst reports. With the exception of management's prediction of earnings, the individual security analyst should be able to collect all information about a company the corporate managers are willing to disclose to him if he is prepared to keep it confidential and to make his completed report available to the public. Such reports can exist in a scheme of market operation based on equality. To the extent that security analysts are the only persons receiving inside information, purchases made on direct communications of such information will be easy to detect. In the case of a wide-spread leak, the source of the disclosure can be narrowed to the analysts who have communicated with the company. Only after a breach of the confidential disclosure would it be necessary to decide whether the information was of the kind that must be disseminated to the public if it is to be disclosed at all.

Security analyst meetings should not come under the "privileged" status outlined above. Too many analysts will receive inside information to afford easy detection of its use or disclosure. Such news should simultaneously be disseminated to the public through the news services. The hard problem is whether the meetings should be prohibited unless all information not already in the public sphere is transmitted to the public, or whether a fact-by-fact determination of "materiality" can be made. Confusion on this issue appears in an address by Ruddick C. Lawrence, Vice President of the New York Stock Exchange:

[A] frequent question is: Should information given to market analysts be made available to news media? The answer is: Yes, the essential data should be available to all. If an executive's address to an analyst group will include previously unreleased information, a press release should be prepared for simultaneous distribution. The best guide here is, when in doubt, prepare the release. At first Mr. Lawrence seems to be saying that all information not already available to the public must be included in the press release. At the end, however, he suggests that there may be some doubt as to what should be included. This sounds more like a judgment as to materiality than a search for news which has already been distributed to the public. Mr. Lawrence's use of the word "essential" is itself ambiguous: does he mean it to be synonymous with material, or that jokes should be omitted before sending the address to the news services? The more stringent rule is preferable. The opportunity to so easily avoid a determination of materiality is very tempting. It is also the only sure method of ending a daily public display of the importance


109. Although the availability of facts is better achieved when the information appears in newspapers, the ability to obtain an analyst's report by simply walking into the brokerage house must be considered sufficient. Greater equality through greater accessibility can only come about when the major newspapers expand their financial news coverage.

of inside information. The result of requiring the release of all information not already available to the public may be that analyst meetings will disappear from the scene. In the first place, the news media may not be capable of fulfilling the task of simultaneous distribution of all this information. Secondly, the analyst will have little incentive to attend meetings. If this is the price that must be paid to reduce the flow of inside information, it is a bargain.

Aside from the suggested prohibitions on disclosures to security analysts, other private disclosures by corporate managers, now permitted, should be held unlawful because of the content of the information. There are two kinds of information, not now considered material, which account for a large part of the flows of inside information and which are so material in every instance that they should not be privately disclosed.

First, the prediction of earnings by corporate officers and directors should remain in the confines of management until the time, if ever, it is disseminated to the public through the news services. The routine prediction of earnings by management is not at present considered to be the kind of information which is so clearly "material" that it must be immediately disseminated to the public. Nor does there seem to be any feeling that it must not be disclosed to a limited number of persons. The Special Study uncovered instances in which individuals and groups received a prediction of earnings, and concluded that the harm lies in the possibility that the prediction is inaccurate.

An earnings prediction intelligently arrived at is crucial to investment decisions. It goes to the very heart of security prices. Corporate managers are uniquely qualified to make the prediction. They not only have available current financial and other data but also, as one writer has explained it: "Those who spend a lifetime in any business acquire feelings about the way things are going, often with only vague facts to pin to." A few words such as "earnings will be up" or "it looks like we'll earn about $.50 for the quarter" may summarize all of

111. In 1965 there were approximately 5,500 security analyst meetings, many of which were not covered by the news media. See pp. 193-94 and note 16 supra.

112. Under the proposed solution, question-and-answer periods would be eliminated. Therefore, the only advantage to be gained by attending, rather than reading the newspaper account of the meeting, is the chance of establishing a personal contact with the speaker. This type of analyst-management communication would not receive a "privileged" status because it does not contemplate a thorough study of the company followed by a report that is available to the public.

113. It might be argued that the flow of inside information which takes place at security analyst meetings would be replaced by individuals contacting management to a greater extent than is done at present. However, the proposed restrictions on analyst meetings, along with the suggestions for broadening materiality discussed herein, should convince corporate managers that they are on dangerous ground when they disclose information to "outsiders." Also, analyst meetings have themselves been responsible for the establishment of contacts, see, e.g., Special Study, supra note 9, at 78, which do not always lead to reports that are made publicly available.

114. See, e.g., New York Stock Exchange, supra note 86, at 4. However, disclosure of a predicted drop in the earnings of Douglas Aircraft is the basis for the S.E.C.'s recently filed administrative proceedings against Merrill, Lynch, Pierce, Fenner and Smith, Inc. and certain of its institutional investors. See Wall Street Journal, Aug. 28, 1968, at 3, col. 1.

115. Special Study, supra note 9, at 90.

116. Royster, supra note 106.
the inside information available to management. It is not surprising then, that security analysts attempt to elicit this information from corporate managers. One analyst told the Special Study: "I can't imagine any group of analysts being together with company officials and not asking [for earnings predictions]. That would be one of the first questions we would ask. . . ."117 The New York Society of Security Analysts has publicly stated that it thinks analysts deserve to receive this information:

The heart of security analysis is the forecast. Management’s forecast, based upon sound planning can be of great help to the analyst. . . . The company is justified in not giving current figures to analysts prior to general publication but it can be helpful to the company and the analyst if the trend of current earnings is discussed.118

Security analysts, regardless of the confidential capacity in which they receive the predictions, should be subject to the same rules that apply to others who seek inside information. The reason for allowing analysts to communicate with management is that the information they receive will aid them in reaching their own forecast of earnings. Furthermore, management's prediction of earnings is too valuable a piece of information to entrust to anyone.

This addition to the category of material information will not only be a significant step toward ending the practice of trading on tips, but it will also have a high chance of successful operation. Experience in the area leads to the conclusion that voluntary compliance with the prohibition would be forthcoming. Persons will often go to great lengths to hide the fact that a prediction of earnings had been disclosed. Although it may be permitted, they have a visceral feeling that it should not be. A public confirmation of their belief would afford corporate managers a more forceful justification when pressured for a prediction of earnings to refuse to disclose this information. If leakage occurs, the problem of detection is not as great as with other kinds of inside information. Knowledge of an ore strike, for example, is obtainable by many persons outside of the company, such as geologists and landowners residing near the strike. Management's prediction of earnings, on the other hand, is a creation of the mind based on data accumulated within the company. It is usually clear which officers are privy to the financial records of the corporation on a day-to-day basis and they and their tippees should be held responsible if leaks occur.

117. SPECIAL STUDY, supra note 9, at 90.
118. NEW YORK SOCIETY OF SECURITY ANALYSTS, CORPORATE RELATIONS 4. The term “trend of current earnings” is an example of circumvention of a prohibition against disclosures of earnings predictions. An inquirer should not be able to say: "I cannot ask for an earnings prediction but how do the figures on costs and sales look?" This information is in some cases already covered by management's duty not to disclose facts that would aid the company's competitors. Perhaps the standards of the New York Stock Exchange, as discussed earlier, include this situation. It is unlikely, however, that the Exchange contemplated the reasons given in this article when it constructed this “rule.”
Second, the concept of materiality must include information which
does not relate to the intrinsic worth of the company but does bear on
the price of its stock. This standard should be applied to two kinds of
information which clearly fall within its language: an imminent maga-
zine article, and a stock "push." This "news" does not usually emanate
from management, but it is just as potent in creating unevenhanded
stock transactions as the more common types of inside information.
The knowledge of an impending magazine article about a corporation
has been shown to be a valuable piece of information because the price
of the corporation's stock usually rises immediately after the article is
published.\textsuperscript{119} The write-up may include only information which is
already available to the public, but it is the highlighting of these facts
in a widely circulated periodical that causes the price of the stock to
advance. The Special Study describes instances in which writers have
profited from this information,\textsuperscript{120} but, in keeping with its myopic con-
cern, it only fears that such situations may produce exaggerated claims
about the company because of the writer's ownership of stock. As is
common with the more usual forms of inside information, the possessor
often communicates what he knows to others,\textsuperscript{121} creating a tipper-tippee
relationship. The stock "push" derives its value from the creation of
interest in a stock. A group of people make large purchases of a stock
with the hope that the rest of the market will join in. Success is often
the result because other investors assume the initial purchases were
based on a lead of inside information, or that the stock is being
"pushed," and they may be able to make a few "points." Like the
chain-letter enterprise, the trick is to get in from the beginning. Al-
though the purchase of stock with the intention of creating market
demands is prohibited under Section 9 (a) (2) of the Securities Ex-
change Act,\textsuperscript{122} it would be helpful to include the knowledge of it under
the rubric of material inside information. Moreover, corporate manage-
ment may sometimes help such an effort by informing a few persons
of corporate news not available to the public. This information, re-
gardless of whether it is considered material in a normal context, should
be so defined when it is knowingly part of a stock "push."

VI. Conclusion

There is growing evidence of the prevalence of tipping of inside
information about corporations to persons who purchase stock based
upon that information. Groups of security analysts exist mainly for the
purpose of holding meetings at which corporate managers disclose in-
formation which is not publicly known or available. Financial public
relations firms also aid the private flow of corporate information. This
has created a class of persons who are trading stock without the same
information, or the same access to information, as the other parties to

\textsuperscript{119} Special Study, supra note 9, at 70-78.
\textsuperscript{120} Id. This is shown by specific communications in some cases, and in others
by a general rise in the price of the stock shortly after publication of the article.
\textsuperscript{121} Id. at 83.
the transaction. It has also resulted in a market place in which "what you know" is dependent in large part upon "whom you know."

Rule 10b-5 as interpreted by the courts requires a showing that the undisclosed information was material. In reversing the district court's decision in *Texas Gulf Sulphur*, that the insider traders and tippers were not dealing with material information, the Second Circuit has promulgated a new definition of materiality. The great breadth of this test is justified by a recognition that almost all information is of value to traders however uncertain and indefinite it may be. A question still remains as to how this definition will be applied by other courts to other facts. There should be a difference in the meaning of materiality for each context in which it arises; that is, for the failure by management to make a public dissemination of material corporate news, for insider trading, and for insider tipping. The above analysis suggests that at the least it should be recognized that news which is not sufficiently material to require dissemination to the public, or to require disclosure for insider trading purposes, is not necessarily so immaterial as to be available for private disclosure. At the most it could be said that private disclosures serve no justifiable or worthwhile purpose and therefore should be absolutely prohibited regardless of how immaterial the information might be. A middle course would suggest that security analysts be permitted access to relevant corporate data so long as this information is not the "end product," *i.e.*, a prediction of earnings, and so long as they are prepared to keep it in their confidence until a time when they will make it available to all. All other disclosures would be prohibited unless they are required by law, such as under the "reasonable basis rule" or in the case of reports to regulatory agencies, or unless a business necessity or convenience exists, such as reports to banks.

The Securities and Exchange Commission is vested with the power to adopt such rules under Section 10(b) and have them enforced by criminal sanctions under Section 32. The Commission should utilize that power. If this is not done, other courts in insider tipping cases should follow the Second Circuit's expanded concept of materiality, recognizing the policy distinctions between tipping and trading, and including as material such obvious areas as predictions of earnings and information which bears on the price of a stock but not necessarily on the intrinsic value of the company.

The law in the area of unevenhanded stock transactions has been primarily concerned with insider trading rather than insider tipping. In both situations, the result is a "defrauded" investor, but where tipping is involved the culpability is shared by two persons, the tipper of the information and his tippee. Section 10(b) of the Securities and Exchange Act and Rule 10b-5 can be more easily applied to the corporate manager who is a trader on inside information than to the corporate manager who is just a tipper of inside information, or to his tippee who transacts in shares based upon that information.

Although insider trading falls more clearly within the language of these anti-fraud provisions, insider tipping is less capable of justification and is therefore more within the "spirit" of the prohibition of 10b-5. Corporate managers should be encouraged to own shares in
their own corporations to insure their loyal participation in the organization. Although this justification does not mean that we ought not to be concerned about the disparity of information between shareholder and manager, it does suggest that there are affirmative reasons for allowing corporate managers to purchase stock in their own companies. However, there would appear to be no such justification for insider tipping. The only argument to support insider tipping, aside from one based upon the idea that transacting in the stock market is like gambling and therefore subject to the rules of \textit{caveat emptor} and \textit{caveat venditor}, is that it is a necessary flow of information. A high premium should be placed on the free flow of information in the market place, but insider tipping does not beneficially advance that objective and has the negative impact of creating a substantial disparity of information between the tippee and other parties not privy to the inside information. Private disclosures are an unevenhanded flow, reaching some persons and not others, and reaching many by the unreliable medium of rumor.

To justify either insider trading or tipping, one might point to transactions in land and argue that the law does not always require a purchaser to disclose all the information at his disposal. That rule finds justification in many situations because it encourages people to undertake the task of uncovering our natural resources, and because it involves information which is more patent than inside information, which requires contact with a corporate manager.

Also, the courts should place the burden of pecuniary compensation to the injured investor on the tippee, but the tipper, in particular the corporate manager who is responsible for the disclosure, should suffer the criminal penalty.

In the final analysis, the news media must bear the great burden of disseminating more news to the public. Their role must increase as private disclosures decrease. This must be done not just for the help it will provide to the investor, but for the benefit it will bestow upon the market by making it a more professional enterprise, and for the reason, as stated by Professor Cary, that: "... integrity in the capital markets is essential for mass capitalism."\textsuperscript{123}