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Broker-Dealer Disclosure of Corporate Inside Information

James K. Weeks* and Jeffrey V. McCormick**

The problem of when, how and where to utilize inside information so as to avoid legal consequences of untimely or improper disclosure has been of considerable concern to corporate officials very recently.

Prior to 1968 many business executives apparently felt that it would not be improper to take advantage of inside information for their own personal gain, and perhaps to let a few close friends in on the information as well.¹

Although the individual attitude of corporate officials today toward the use of inside information may not have changed as a matter of personal ethics, there can be little doubt that recent events have superseded personal values and imposed a vague legal requirement in their stead. The boundaries of this new standard are not fixed. It has confused rather than clarified an already murky issue.

The alternatives open to insiders, corporate employees and their tippees have seemingly polarized themselves, at least in the minds of some businessmen, to either telling nothing to anyone or shouting even the most insignificant (although significance or insignificance is more often than not determined by hindsight) bit of corporate news from the proverbial housetops. However, there exists a large middle ground, which requires exploration to establish and formulate guidelines and rules regarding the proper disposition and use of corporate inside information. The actualities are that it is not necessarily an "either/or" proposition and that in fact there may still be a considerable body of inside information which under proper circumstances may be acted upon without the initial soul baring thought to be presently required.

If the responses to the abovementioned Harvard Business Review questionnaire are indicative, a large number of corporate executives appear to have few qualms about utilization of such information for their own gain, and certainly no reservations regarding the avarice of their peers.²

² 1,700 executives responded to a question regarding the use they would make of information gleaned from a Board of Directors meeting which indicated that a proposed merger plan, as yet undisclosed to the public, made the purchase of stock of the proposed "mergee" highly profitable (the stock was selling low but was certain to rise upon public disclosure of the merger) as follows:

(Continued on next page)
The above responses indicate that "... a surprising, and perhaps shocking, number of executives feel that it is perfectly reasonable conduct to use inside information for their personal benefit." The inadvisability of following such a course of action as the Harvard survey indicates is well expressed in a New York Stock Exchange Educational Circular which defines the policy of the Exchange in such situations. The following excerpt exemplifies the feeling of the Exchange:

Every director has a fiduciary obligation not to reveal any privileged information to anyone not authorized to receive it. Not until there is full public disclosure of such date, particularly when the information might have a bearing on the market price of the securities, is a director released from the necessity of keeping information of this character to himself. Any director of a corporation who is a partner, officer, or employee of a member organization should recognize that his first responsibility in this area is to the corporation on whose Board he serves. Thus, a member firm director must meticulously avoid any disclosure of inside information to his partners, employees of the firm, his customers or his research or trading departments.

Furthermore, the same rules should be considered applicable where a representative of a member organization is not a director but is acting in any other advisory capacity. Therefore, the policies of those whose duty it is to regulate the securities market would appear to be in direct conflict with the prevailing attitude in the corporate community. In light of this conflict, it should be of some assistance to examine the appropriate legislative and judicial approaches to the problems of maintaining an open market for the purchase and sale of securities.

But when asked what they thought others would do answered as follows:

<table>
<thead>
<tr>
<th>Action</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buy themselves</td>
<td>61%</td>
</tr>
<tr>
<td>Tell a broker</td>
<td>11%</td>
</tr>
<tr>
<td>Tell a friend</td>
<td>46%</td>
</tr>
<tr>
<td>Do nothing</td>
<td>29%</td>
</tr>
</tbody>
</table>

3 Cary, The Direction of Management Responsibility, 18 Bus. Law. 29, at 33 (1962–3). For a survey of the governmental views, see, 2 Oleck, Modern Corporation Law, c. 34 (Government Regulation of Securities), c. 35 (Securities Markets), c. 36 (Securities Problems of Small Corporations) (1959, with 1965 supp.).

4 New York Stock Exchange Member Firm Educational Circular No. 162 of June 22, 1962. And see, supra, Oleck, c. 29 (Methods of Corporation Financing, Generally), and c. 42 (Directors’ and Officers’ Conflicts of Interests).

The Case Against Merrill Lynch, Pierce, Fenner and Smith

The recent administrative proceeding of the Securities and Exchange Commission (SEC) against Merrill Lynch, Pierce, Fenner and Smith, Inc. is representative of the problems faced by the brokerage community in the area of disclosure of corporate information following the recent case of SEC v. Texas, Gulf & Sulphur Co., et al. The SEC alleges in its complaint in Merrill Lynch that during the period from June 17, 1966 through June 24, 1966 Merrill Lynch violated and willfully aided and abetted violations of Section 17(a) of the Securities Act of 1933, Sections 10b and 15(c) (1) of the Exchange Act, and Rules 10b-5 and 15c1-2 thereunder in connection with the sale and purchase of Douglas Aircraft securities. Merrill Lynch, because of its position as prospective managing underwriter of a Douglas offering of convertible subordinated debentures, obtained from Douglas management nonpublic material information that Douglas would report sharply lower earnings for the first six months of the 1966 fiscal year and that Douglas had sharply reduced its estimates of earnings for 1966 and its projections of earnings for 1967. Acting upon this information, Merrill Lynch disclosed these reports to a number of its institutional investors and other large customers who were also included in the complaint. Several of these customers thereafter sold Douglas stock from existing positions and effected short sales of more than 19,000 shares of Douglas stock on the New York Stock Exchange and otherwise, prior to public disclosure of the information and without informing the purchasers of the stock of the decline in earnings. If the allegations of the SEC are found to be true, then the SEC has requested remedial action in the public interest under

7 401 F. 2d 833; CCH Fed. Sec. L. Rep. ¶ 92,251 (2d Cir. 1968). The Texas, Gulf & Sulphur litigation involves the discovery of an ore deposit near Timmins, Ontario, Canada. The area was first thought to have promise in 1959 and in 1963 the drilling of the first test holes began. On November 12, 1963 preliminary drilling of the first hole was completed, which indicated a valuable deposit of ore. Public announcement of the discovery was not made until April 16, 1964, but in the meantime numerous insiders had been actively purchasing shares of stock in anticipation of substantial gains. These insiders were held by the court to have violated the antifraud provisions of the securities laws.
9 Ibid. § 78j (b).
10 Id. § 78o (c) (1).
11 17 C.F.R. § 240.10b-5.
12 Ibid. § 240.15c1-2.
13 15 U.S.C.A. § 77(b). The term underwriter means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such a term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributor's or seller's commission. . . .
Sections 15(b), 15A\textsuperscript{14} and 19(a) (3)\textsuperscript{16} of the Exchange Act and Section 203\textsuperscript{17} of the Investment Advisors Act of 1940.

**Who Is Required To Disclose**

Before examining what is required to be disclosed, it is of interest to determine who has the duty to make disclosure and when. In this respect Rule 10b-5, which is directed primarily against misrepresentations and nondisclosures, should be consulted, and particularly the language, "any person" appearing in the first line. The future application of the Rule will be determined by the extent to which the courts and the Commission apply the language "any person."\textsuperscript{18} Although the language probably will not be literally applied, the courts have come a long way since 1952 when a representative of the SEC expressed the then prevailing interpretation of the language "any person" as follows:\textsuperscript{19}

Mr. Byrne: They (SEC) agree 100% that an insider cannot take advantage of a stockholder of his company in connection with the purchase from him or the sale to him of the company's stock where he has information not known to that man on the other side of the transaction because of his fiduciary obligation to disclose it to him. I do not believe, however, the Commission takes the second and third steps in their current consideration of X10B5, and by second and third steps I mean this: that insider could communicate to an outsider the same information he knows, and the outsider might act on it and unless the Commission had evidence from which they could conclude that the insider was a party in fact to the transaction, either acted in concert with or conspiracy with the outsider, I do not think that they would hold the outsider in violation of Rule X10B5; and your third case is what I call the locker-room case... where a fellow at the golf club overhears the insider talking to a friend of his and he himself acts on the basis of the information he heard and that case I do not think the Commission would touch at all at this stage of its existence.

Mr. Heller: Would they hold the insider?

Mr. Byrne: They would hold the insider without question in the first case; in the second and third cases they would not hold the outsider who had the inside information, unless they could show a conspiracy or concert of action with the insider, in which event they

\textsuperscript{14} 15 U.S.C.A. § 78o. Suspension and Revocation of Registration.

\textsuperscript{15} Ibid. § 78o-3. Suspension and Expulsion from Membership in the National Securities Association.

\textsuperscript{16} Id. § 78s. Suspension and Expulsion from Membership in National Securities Exchange.

\textsuperscript{17} Id. § 80b-3.


would hold both of them, and in no event would they hold the locker room man.

In 1961, in the case of *In re Cady, Roberts & Co.*20 the Commission went well beyond the view that a "concert or conspiracy" was necessary to hold the outsider. As described by the Chairman of the SEC, *Cady, Roberts* was "... a case of first impression and one of signal importance in our administration of the Federal securities acts."21 The decision held that a partner in a brokerage firm who had learned of a dividend cut by Curtiss-Wright from an employee of the firm who was also a director of Curtiss-Wright violated Section 17 of the Securities Act of 1933 and Rule 10b-5 under the Securities Exchange Act of 1943, by executing sell orders for discretionary accounts22 on the New York Stock Exchange prior to the public announcement of the reduction.

The decision is important for several reasons: First, it was clearly established that nondisclosure was an "act, practice or course of business" operating as a fraud or deceit within the meaning of clause 3 of Rule 10b-5. Second, the case held that the Rule could reach nondisclosure by persons who were not "insiders" at common law. Third, the Commission found that a duty of disclosure was owed even in sales to unidentified persons on a public exchange. Fourth, the Commission expressed the view that the duty of disclosure owed to the public was greater than the broker's fiduciary responsibility to his discretionary accounts. And finally, it disclosed an awareness of the importance of the development of implied civil liability.

Of all of these, the aspect of the case which would appear to have the greatest impact was the extension of the rules on who must disclose other than the traditional insiders which included officers, directors and controlling shareholders. The Commission observed:

We have already noted that the antifraud provisions are phrased in terms of "any person" and that a special obligation has been traditionally required of corporate insiders, e.g., officers, directors and controlling stockholders. These three groups, however, do not exhaust the classes of persons upon whom there is such an obligation. Analytically, the obligation rests on two principal elements: first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

... Intimacy demands restraint lest the uninformed be exploited.23

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21 Id., at 907.
22 A discretionary account is one for which the broker has the power to conduct transactions at his discretion without first obtaining the specific permission of the account holder. See Leffler, *The Stock Market*, 166-167 (2d ed. 1957).
23 Supra note 20, at 912.
Prior to Cady, Roberts the court had not stressed the use of the phrase "any person," however, Rule 10b-5 had been applied to brokers where they had made and caused others to make false and misleading statements of material facts, or where a broker has omitted to state a material fact, or finally where a brokerage firm which was dominated by a partner who was also a director of a company which issued certain securities, induced the sale of such securities by material misrepresentations and misleading omissions as to the assets and prospects of the issuer.

It therefore does not require much stretch of the imagination to include an underwriter of an issuance of stock or convertible debentures, such as Merrill Lynch, within that class of persons who have access to information intended for a corporate purpose, and where such person has unfairly taken advantage of such information as where large customers and institutional investors are advised of a decline in earnings before it is made public, and purchasers of the same securities are not provided with the same information. The duty applies not only to brokers affiliated with a director of an issuer as in Cady, Roberts, but also to "any person" in possession of material undisclosed information. A broker may also be liable for violation of 10b-5 if he aids an insider to violate the Rule.

Thus, the ultimate test of whether an individual is within that class of persons upon whom there is a duty to disclose or, in the absence of disclosure, to refrain from trading in a corporation's securities is whether or not that person has access to material inside information.

What Facts Are To Be Considered Material?

Where there is no disclosure, in order to hold an insider liable, whether he is a director, officer, major stockholder, employee or broker, the misstatement or unfair use of nonpublic information must be of a material fact. This requirement of materiality is necessary to protect against an outsider's use of the insider's misrepresentation or nondisclosure "as a pretext for escaping a bargain that [the outsider] is dissatisfied with on other grounds."

The test to be applied in determining when a fact is material was expressed in Kohler v. Kohler as a fact "which in reasonable and objective contemplation might affect the value of the corporation's stock or

27 Supra note 7, at 848.
29 Keeton, Actionable Misrepresentation, 2 Okla. L. Rev. 56, at 59 (1949).
30 319 F. 2d 634 (7th Cir. 1963).
securities...". However, in applying this test, the court refused to hold defendants liable where plaintiff had sold his stock in the corporation back to the issuer alleging that he was induced to do so by misrepresentation by the defendant corporation and the accountant who was retained to negotiate the sale of stock. The court held that there was no breach of duty on the part of the accountant in failing to volunteer details of a pension plan or of an accounting method as to how annuities were funded on the books of the corporation even though a different method, if adopted, would have increased the book value of the company. The court reasoned that insiders "are not required to search out details that presumably would not influence the person's judgment with whom they are dealing." 32

The test is essentially whether a reasonable man would attach importance to the facts if known in determining what course of action he should pursue in the management of his investments.33

The courts have had several opportunities to decide what facts are to be considered material. Some of these situations include: the fact that a control group had a purchaser for all of the corporate assets that would result in a higher price for the stock than that paid to the outsider who owned the stock;34 or where a reduction of the dividend rate was undertaken in order to depress the price of the stock to facilitate the purchase of the stock by a control group at a lower price;35 and where there is a significant improvement in the business condition of a company;36 or a proposed private and public offering of a company's shares at prices greatly in excess of the price at which they were purchased from an outside shareholder.37

In addition to and including those areas which the courts have considered to be material, the New York Stock Exchange has included negotiations leading to acquisitions and mergers, stock splits, the making of arrangements preparatory to an exchange or tender offer, changes in dividend rates or earnings, calls for redemption, new contracts, products, or discoveries.38

31 Id., at 642.
32 Id., at 642.
38 Supra note 5, at A-19.
The mere fact that material information exists of which top management and their confidential advisers, such as underwriters, have knowledge, does not mean that it must be immediately disclosed to the public. As was indicated in footnote number 12\textsuperscript{39} of \textit{Texas, Gulf & Sulphur}, where a corporate purpose is served by nondisclosure of a material fact, public announcement may properly be avoided. However, adequate security to prevent leaks of the material information should be maintained which requires that market action in a company's securities should be closely watched, and if unusual market activity should occur, then the company should be prepared to make an immediate public announcement of the matter.\textsuperscript{40}

In \textit{Merrill Lynch} the underwriter's alleged knowledge that Douglas would report sharply lower earnings would surely seem to fit within the tests offered for determining materiality. The fact that certain of the institutional investors and other large customers of Merrill Lynch acted upon the information would appear to be evidence that a reasonable man would have attached importance to the facts if known. Since nonpublic information possessed by a broker is likely to influence any transaction in which he is engaged, the most satisfactory solution would be to place a duty upon the broker to disclose all material inside information as soon as he practically can.\textsuperscript{41} In the alternative the broker should refrain from dealing in the company's securities until there has been adequate public disclosure.

\textit{Implied Civil Liability for Violation of 10b-5 by Insiders and Their Tippees.}

Not only may the SEC act on violations of the federal securities laws, but defrauded parties to a transaction have also been held to have a cause of action. Under the common law of deceit, where the parties dealt at arms length and there was no existing fiduciary duty, liability was imposed only for misrepresentations or for omission to state a material fact which, in light of the statements made, make such statements misleading. However, mere nondisclosure did not constitute any breach of duty.\textsuperscript{42} However, where a fiduciary relationship existed at common law as between a broker and his client,\textsuperscript{43} the courts were not consistent in the duty which they imposed. The majority rule held that an officer or director of a corporation only owed a fiduciary duty to his company

\textsuperscript{39} \textit{Supra} note 7, at 850.
\textsuperscript{40} \textit{Supra} note 5, at A-19.
\textsuperscript{41} Note, Broker Silence and Rule 10b-5: Expanding the Duty to Disclose, 71 Yale L. Rev. 736, at 746 (1962).
\textsuperscript{42} Prosser, Torts § 101 (3d ed. 1964).
\textsuperscript{43} Note, SEC Rule 10b-5 Invoked to Suspend Broker Who Failed to Disclose Inside Information When Selling on National Exchange, 62 Colum. L. Rev. 735, at 737 (1962).
and that in stock transactions with shareholders he could deal at arm’s length as if with a stranger.\textsuperscript{44} On the other hand, a minority rule developed which required the insider to disclose all material facts concerning the value of shares known to him but not a matter of public information.\textsuperscript{45} Still another approach at common law was to impose a duty to deal fairly and disclose all known material facts in face-to-face transactions where the insider personally sought out the shareholder to buy his shares.\textsuperscript{46} This last approach resulted as an exception to the majority view and was applied by the Supreme Court in \textit{Strong v. Repide}\textsuperscript{47} even where the transaction was handled by a broker. The court in that case imposed a duty on corporate officials to disclose “special facts” affecting the value of shares. However, no court at common law held there was a duty to disclose inside information when a transaction was effected on a stock exchange.\textsuperscript{48}

The laxity of standards applicable to insider trading eventually resulted in federal legislation, including Section 10(b) and Rule 10b-5 which was made applicable to both purchases and sales of securities. Despite the contention that Rule 10b-5 was not intended to create civil liability and was meant only to give rise to injunctive relief or to possibly administrative remedies, it has been held ever since \textit{Kardon v. National Gypsum Co.},\textsuperscript{49} decided in 1946, that Rule 10b-5 carries with it implied civil liability.

The rule still exists that where there is no fiduciary relationship nondisclosure of a material fact is not actionable.\textsuperscript{50} However, where a fiduciary relationship exists insiders have a duty to disclose material facts which would affect the value of shares when they have knowledge of material inside information which is unknown to the other party. As expressed by Judge Friendly in his concurring opinion in \textit{Texas, Gulf & Sulphur}, “Silence, when there is a duty to speak, can itself be a fraud.”\textsuperscript{51}

In order to award compensatory damages for violation of 10b-5 and 17(a), the jury must find that the defendants made:

\begin{enumerate}
\item False or misleading statements
\item with respect to material facts
\item with knowledge that the statements were false or misleading, or of the existence of facts which, if disclosed, would reveal them to be false or misleading, and that
\item the plaintiffs relied upon
\end{enumerate}

\textsuperscript{44} Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933).
\textsuperscript{45} Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903).
\textsuperscript{47} 213 U.S. 419 (1909).
\textsuperscript{49} Supra note 34.
\textsuperscript{50} Trussell v. United Underwriters, Ltd., 228 F. Supp. 757 (D. Colo. 1964).
\textsuperscript{51} Supra note 7, at 865.
the statements as substantial factors in determining their course of conduct (as distinguished from justifiable reliance) (5) with resulting damage.\textsuperscript{52}

The element of \textit{scienter} which must be established in a civil action where the parties deal at arm's length\textsuperscript{53} need not be established when there is a fiduciary relationship either against the purchaser or seller. Proof of specific intent to defraud in such situations is unnecessary whether the action is an SEC enforcement proceeding or a private civil suit.\textsuperscript{54}

The test for reliance which the plaintiff must establish is whether the misrepresentation or nondisclosure was a "substantial factor in determining the course of conduct which results in (the plaintiff's) loss."\textsuperscript{55} And finally, it should be noted that privity of contract is no longer a necessary element to be established in a suit for damages under 10b-5. In \textit{Gann v. Bernzomatic Corp}.\textsuperscript{56} plaintiff brought an action alleging that defendants distributed untrue and misleading statements and induced members of the public to purchase stock which the defendants were anxious to unload. Plaintiffs purchased the stock over an 18-month period in reliance on defendants' representations, and the court held that even though no allegation was made that plaintiff purchased the particular shares which the defendant sold, a cause of action existed. Although the defendants relied on \textit{Joseph v. Farnsworth Radio and Television Corp}.\textsuperscript{57} which required a "semblance of privity," the court suggested that an allegation of reliance might be sufficient.

Not only may compensatory or actual damages be awarded in a civil action, but in addition punitive damages are proper if the requisite tests are met. In \textit{Globus v. Law Research Service, Inc.}\textsuperscript{58} the jury was instructed that if, in addition to the above five elements of a civil action, they found that the fraudulent conduct involved a high degree of moral culpability, wanton dishonesty, moral turpitude, gross fraud and deceit upon the public and a wanton indifference to one's obligations, punitive damages might be awarded in addition to compensatory damages.\textsuperscript{59}

\textsuperscript{55} Restatement of Torts, § 546 (1938).
\textsuperscript{57} 99 F. Supp. 701 (S.D. N.Y. 1951), aff'd, 198 F. 2d 883 (2d Cir. 1952).
\textsuperscript{58} Supra note 52.
\textsuperscript{59} Id., at 194.
In *Globus* the court found that there was sufficient evidence to support an award of punitive damages where there was a violation of 17(a). The court found that an underwriter of a public offering of 100,000 shares of common stock of Law Research Service, Inc. prepared an offering circular which described the company's business as "a law information retrieval program for the legal profession by applying computer technology to the problems of legal research." However, the circular failed to mention the fact that a five-year contract with Sperry-Rand Corporation, under which Sperry-Rand was to provide programming and computer time and which contract was an attractive feature to the public, had been recently terminated by Sperry-Rand. The circular further omitted reference to the fact that Law Research had instituted a lawsuit against Sperry-Rand for breach of contract, fraud and deceit, specific performance and conspiracy. Based on the above facts, the court upheld a jury verdict for the plaintiffs for both compensatory and punitive damages.

A Section 10(b) action may be brought pursuant to Section 2760 by the Commission or by any party claiming to have been defrauded. There is no longer much doubt but that the insider may be held liable where he profits from material inside information or where he is found to have informed others. The Circuit Court in *Texas, Gulf & Sulphur* clearly established the culpability of tippers when it held that Darke (a defendant) violated Rule 10b-5(3) and section 10(b) by "tipping" and remanded "... for a determination of the appropriate remedy."61 The next question is whether a "tippee" who benefits from a tip is also liable for damages. The complaint in *Merrill Lynch* included a number of investors who allegedly sold Douglas stock following the tip by Merrill Lynch as to the decline in earnings. The question thus is whether these tippees may be held accountable to the uninformed purchasers of the stock. Although there is a greater reluctance to apply the fraud provisions of the securities acts to the tipper-tippee situation,62 the *Texas, Gulf & Sulphur* opinion is of interest on the extent of a tippee's liability. It would seem that a tippee does commit an unlawful act within the meaning of 10b-5 when he uses material, undisclosed information "... in connection with the purchase or sale of any security ..." when such a transaction "... would operate as a fraud or deceit ..." upon the other party. The access test as expressed in *Cady, Roberts* and *Texas, Gulf & Sulphur* would appear to encompass not only the first-hand recipients of inside information, but the second-hand recipients as well. The culpability of tippees, although not an issue in *Texas, Gulf & Sulphur*, was discussed by the court:

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61 Supra note 7, at 864.
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. 63

Support for holding tippees liable may be found in Ross v. Licht 64 where the court was willing to hold tippees liable even though they might not be considered insiders. The tippees in Ross v. Licht were close friends of a family which controlled a corporation. The tippees purchased the plaintiff's stock at $120 per share without disclosing a proposed private sale of the stock at $300 per share and a proposed public offering of the stock at $600 per share. The court concluded that:

If Sidney, Grapel and Bluestone (the defendants) were not insiders, they would seem to have been tippees (persons given information by insiders in breach of trust) and subject to the same duty as insiders... And in any event, Sidney, Grapel and Bluestone would be equally liable with the other defendants for aiding and abetting a violation of Rule 10b-5. 65

After consideration of the relevant law on the insider's and tippee's civil liability for violation of 10(b), 10b-5 and 17(a), it would appear that if the facts alleged in the complaint against Merrill Lynch were established 66 then a private cause of action would seem to exist for the purchasers, who were not informed of the decline in earnings, against Merrill Lynch as an inside tipper and the selling investors as tippees. This does not mean that anyone who buys or sells based on a tip should be held liable in private suits or in proceedings by the Commission. Since implicit in the access test is the idea that violation should depend on knowledge, whether actual or constructive, that the material undisclosed information came from a company source. Even though the tippee may escape liability because he is not a knowing confederate, the opinion in Texas, Gulf & Sulphur implies that the tipper may be subject to liability for the profits derived by the tippee from the transaction. 67 Thus, it is not beyond the realm of possibility that Merrill Lynch could be held accountable for the losses suffered by the purchasers of Douglas stock.

63 Supra note 7, at 97,181.
64 Ross v. Licht, supra note 37.
65 Id., at 410.
66 The SEC staff and Merrill Lynch appear to have settled their differences without an administrative hearing, according to The Wall Street Journal, November 27, 1968.
67 Supra note 48, at 132.
Guides for Future Conduct

Corporate insiders are normally in the best position to determine the value of their securities. Brokers and dealers, although less favorably situated, are still in a more advantageous position than the ordinary investor. Therefore, the corporate insider and the corporation should be expected to exercise more care and have a broader duty of disclosure than that owed by brokers and dealers, who in turn have a greater duty to disclose material information than the ordinary investor who may not have any greater duty than existed at common law, which was usually no duty at all unless he fit into the class of persons described as tippees who are aware of the source of their information.

Where a broker arrives at a decision "as a result of perceptive analysis of generally known facts" there should be no danger of intervention by the Commission or of imposition of civil liability. However, as a general rule insider responsibilities should be imposed where the recipient of the information knows, or has reason to know, that the informant has violated a duty to the corporation in divulging the information. Where inside information is acquired, then the primary duty of a broker must be governed by his inside position, rather than by any conflicting fiduciary duties. It therefore follows that if disclosure would be improper or unrealistic under the circumstances, then the alternative is to forego the transaction.

The view has been expressed that the rules of disclosure may result in a withdrawal of brokers from positions as corporate directors. This view is based on the feeling that there is too great a risk that innocent transactions will coincide with new corporate developments and that brokers will then face either civil liabilities, SEC administrative proceedings or both. However, withdrawal of brokers from corporate boards of directors would be undesirable since their opinions can be of great value to companies and to the financial world as a whole. It would further seem that the courts will be unwilling to extend liability to this extreme, and that something in addition to mere coincidence of a transaction with a new development would be required to establish a violation of the antifraud provisions of the securities acts. Not only does it seem unnecessary for brokers to withdraw from directorships, but the New York Stock Exchange Company Manual would also allow insiders to trade in their company's stock under certain limited circumstances. The Exchange has outlined three situations when they feel trading by insiders would be proper which include: (1) where a periodic investment

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68 Supra note 20, at 915.
69 3 Loss, Securities Regulation 1454 (2d ed. 1961).
70 Supra note 20, at 911.
72 Blau v. Lehman, 368 U.S. 403 (1962).
program is established under which the officer or director or presumably any other insider makes regular purchases at predetermined intervals, or (2) where purchases and sales are made during the 30-day period commencing one week after the annual report has been mailed to stockholders, provided that all corporate developments have been adequately disclosed, and (3) where the insider, prior to making a purchase or sale, contacts the chief executive officer of the company to determine if there are any important developments which should be disclosed before participating in the transaction.\footnote{Supra note 5, at A-25.}

If trading in a security of a company in which a person is an insider is sanctioned by the New York Stock Exchange as indicated above, then what happens when a broker, through his own financial analysis, arrives at a decision to buy or sell and before taking action he receives inside material information which confirms the decision he has already made? Although Cady, Roberts implied that a broker might not be disciplined for implementing a decision arrived at prior to the acquisition of inside information, it would seem that some overt act would be required to effect the transaction if liability were to be avoided.\footnote{Supra note 41, at 745.} Such a requirement might seem unfair, but the goals in regulation of the securities market and the need for fairness in all transactions are sufficiently important to warrant such action. In addition, this requirement is consistent with the view that a broker is also a guardian of the securities market and that there are times when his duty as a policeman is greater than his fiduciary duty to his clients and their desire to reap the benefits of his analysis.\footnote{SEC Release No. 6668, p. 12.} Although the primary responsibility for the prompt public release of material inside information is on the issuer, this does not relieve a broker of his duties to the uninformed public.\footnote{Supra note 20, at 915.}

Whether a broker serves as a director, underwriter, market maker, securities analyst or publisher of market reports, if at any time he receives material inside information, he should act with caution. This caution will vary somewhat depending on the degree of his involvement in a particular transaction. Since a broker's activities may range from trading for his own account to merely executing a client's independent decision, it would be helpful to examine whether the disclosure requirements are the same in all circumstances. After the above analysis, there should be little doubt that a broker may not trade for his own account without full public disclosure by the issuer of all material facts which he is also in possession of because of his inside position. The same reasoning would apply where a broker is trading for a discretionary account as was indicated by the opinion of the court in Cady, Roberts. Even

\footnote{Supra note 5, at A-25.}
where the broker offers advice and the client then makes the decision for himself whether or not to undertake a purchase or sale, disclosure should be a prerequisite to executing the transaction. Only where the broker is merely executing a client's independently conceived decision should the disclosure requirements be relaxed, and in such a case the broker's duty should be no greater than his client's.77

Even where disclosure of all material facts is made to the investor and to the public, the duty of the broker to his client is not yet terminated, since a broker also has the responsibility to be certain that his recommendations are based on actual knowledge and are not more optimistic or pessimistic than the facts reveal. As was pointed out in a per curiam decision by the SEC In the Matter of Alexander Reid & Co., Inc.78:

A broker-dealer in his dealings with customers impliedly represents that his opinions and predictions respecting a stock which he had undertaken to recommend are responsibly made on the basis of actual knowledge and careful consideration.

**Conclusion**

The implementation by brokers of the disclosure requirements and the present policies of the New York Stock Exchange should result in greater fairness to all investors and a more orderly securities market. Brokers and companies alike should adopt a policy not to give information to one investor when they are unwilling to give the same information to another investor. And beyond this, both the issuer and the broker who has material inside information should take the responsibility to see that all material information is released to the financial press as soon as possible so as to avoid the possibility of leaks which could result in disciplinary action and possible civil liability.

The recent decisions in the field of securities transactions do not significantly change the legal standards, but they do create an increased awareness of the problems and the limits imposed upon the financial community. It is well established now that a broker's duties to the investing public take precedence over any conflicting duties to his customers or advisees to whom he only owes a duty not to defraud them or profit at their expense. The broker further has a duty to prevent his clients from profiting at the expense of the uninformed public.

The recent SEC proceedings against Merrill Lynch should serve as a warning to the remainder of the financial community. Regardless of how prevalent activities such as those alleged in Merrill Lynch are, it would now seem that the SEC is prepared to put an end to them, and brokers would be well advised to examine their internal policies in regard to disclosure of material inside information.

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77 Supra note 43, at 741.