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Securities Professionals and Rule 10b-5: Legal Standards, Industry Practices, Preventative Guidelines and Proposals for Reform

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SECURITIES PROFESSIONALS AND RULE 10b-5: LEGAL STANDARDS, INDUSTRY PRACTICES, PREVENTATIVE GUIDELINES AND PROPOSALS FOR REFORM

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I. INTRODUCTION

AMID the pervasive gloom on Wall Street, stemming from the prolonged and severe decline in securities prices and the resulting impoverishment of the brokerage industry, securities professionals and particularly security analysts, face a multitude of perplexing questions under rule 10b-5,[1] promulgated by the Securities and Exchange Commission pursuant to section 10(b)[2] of the Securities Exchange Act of 1934. The industry gropes for practical guidelines relating to inside and market impact information. Application of the rule to securities professionals has, thus far, rested on retrospective, ad hoc interpretations by the Securities and Exchange Commission and the courts. The continued expansion of rule 10b-5, under the rationale of promoting its intended remedial purpose, has been greeted with a rending of garments and a gnashing of teeth by the brokerage industry.

Promised elucidation of rule 10b-5 by the Commission has not been forthcoming.[3] In light of the devastating liability exposure of securities

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1. The text of rule 10b-5 is as follows: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (1974).

2. Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1970).

3. The Commission has elicited comments from the industry concerning clarification of the rule. SEC Securities Exchange Act Release No. 10316 (Aug. 1, 1973), [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,446; see Gillis, Inside Information: Are Guidelines Possible, Financial Analysts J., May-June, 1974, at 12.

professionals the purpose of this Article is to (1) analyze current problems encountered by securities professionals under the rule; (2) formulate practical suggestions for attorneys and industry sources for preventative purposes; and (3) present concrete suggestions for reform suitable for consideration and adoption by the SEC.

In order to gain a better insight into the business and economic background of the world in which securities professionals (particularly security analysts) operate and into industry practices in light of promulgated judicial and administrative standards, we conducted an anonymous survey of one hundred randomly selected member firms of the New York Stock Exchange during the spring of 1974.[4] We received sixteen responses to our inquiry, including three refusals to participate in the survey and thirteen answers of varying degrees of helpfulness. Although certainly not a statistically reliable sample, we believe that the data present, in conjunction with personal interviews and supplemental data, a fair representation of the industry's response to some of the most pressing problems encountered by securities professionals under rule 10b-5.

In following up the questionnaires, the senior author conducted in May and June of 1974 a series of eleven focused interviews with junior and senior security analysts, supervisory and compliance personnel, and partners and executives in seven Wall Street brokerage firms. These interviews, each of which lasted from one to three hours, enabled us to understand and to evaluate brokerage industry practices, compliance procedures and suggestions for reform. Further, we corresponded with, and in some instances met with, a variety of additional expert sources, including representatives of the SEC, New York Stock Exchange, American Stock Exchange, Financial Analysts Federation, and New York Society of Security Analysts. These correspondence and meetings produced additional data and served to cross-check brokerage responses and perceptions.

After presenting an overview of rule 10b-5, the functions performed by the security analyst and the methods by which the analyst fulfills his role, this Article will focus on developing practical guidelines, in

4. The questionnaire sought to discern research methods of analysts, reasons for personal meetings with corporate executives, industry perception of applicable legal standards (including the definition of material nonpublic information), and industry compliance therewith, particular procedures for dealing with inside information after its receipt, barriers erected by firms to prevent flow of inside information between departments, and the cost of compliance with rule 10b-5. To our knowledge the only similar research in this area was an Institutional Investor Survey performed in 1973. See note 45 infra. Institutional Investor Institute sent out an unspecified number of questionnaires to both brokerage houses and institutions. Thirty-four responses were received and the Institute held in-depth interviews with each of the thirty-four to supplement the questionnaire.

light of current industry practices, for counsel advising securities professionals, and particularly the security analysts, under rule 10b-5. Our research has shown that the brokerage industry displays great sensitivity to rule 10b-5 problems and that industry procedures attempt to adhere to perceived legal standards enunciated by the Commission and the courts. The firms responding to our survey have indicated that their concerns are to avoid the receipt of inside information generated by the placement of brokerage firm representatives on boards of directors of issuers, and the problems of tippee liability. The unsettled and difficult questions regarding the erection of walls among various departments within the firm and the person or entity to whom the firm, in a conflict of interest situation, owes its ultimate fiduciary duty, met with a wide variety of industry responses. In the absence of authoritative legal prohibitions, the analysts widely rely on building of mosaics, the confirmation of ultimate research conclusions with corporate management, and the utilization of sources outside the corporation to generate additional data and to verify information secured from management. There are also several industry practices in the frontier area of market impact.

On the agenda for reform, we recommend the adoption, where possible, of guidelines by the Commission sanctioning established industry practices which appear to conform with the existing rationale of rule 10b-5 and which appear to serve the public interest. These areas include contacts with corporations, mosaics, and verification of conclusions. We suggest that additional study be devoted to the appropriate standards relating to the erection of walls within a brokerage firm and the problems of market impact. To resolve the almost hopeless task of devising serviceable definitions of "insider" based on the "extraordinary relationship" test and of "materiality," we suggest that the SEC mandate continuous and prompt disclosure of all material information by corporations and that a no-action telephone hotline system be established to provide prospective resolution of the pressing rule 10b-5 problems faced by securities professionals. It appears manifestly unfair for the SEC to hang the sword of uncertainty over those securities professionals who are attempting to conduct business in an ethical and legal manner.

The movement toward the consolidation of brokerage firms[5] should

5. The reduced number of brokerage houses shows up most starkly at the New York Stock Exchange. "A Big Board spokesman said the number of member firms as of [September 1974] was 514, down from 523 at the end of 1973, 558 at the end of 1972 and a peak of 681 at the end of 1961. Earlier this year, Robert H.B. Baldwin, president of the prestigious investment banking firm of Morgan Stanley & Co. and vice-chairman of the [Securities Industry Association], predicted that between 100 and 200 securities firms might merge or go out of business if industry

heighten ethical standards within the industry and render a preventative approach by the Commission the more effective. The current crunch of Wall Street may lead firms to rid themselves of marginal analysts perhaps less attuned to conduct business in an ethical manner.[6] The surviving houses, especially the preeminent firms, increasingly are run as bureaucratic institutions according to hierarchical arrangements and impersonal rules.[7] These bigger firms, Wall Street sources indicated, are generally stronger entities with more far-sighted management and the ability to devote more resources to compliance procedures insuring that legal standards are met. Increased visibility of more firms may also assist in eliminating tipping of inside information by rendering the trading activities of the clients of these firms more readily subject to the surveillance procedures of the New York Stock Exchange and American Stock Exchange.[8]

The growing trend toward professionalism[9] by security analysts probably will also bring an increased recognition of the need to comply

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conditions worsen." Wall St. J., Sept. 20, 1974, at 4, col. 2. See also id., Oct. 2, 1974, at 26, col. 1 (estimates of future brokerage-firm disappearances range from 50 to 200); id., Sept. 17, 1974, at 8, col. 2.

6. See Parker, Ethical Issues for the Financial Analyst, in Corporate Financial Reporting: Ethical and Other Problems (Symposium) 159 (J. Burton ed. 1972); Stern & Brown, Critique, id. at 191.

7. See M. Weber, Bureaucracy, in From Max Weber: Essays in Sociology 196 (H. Gerth & C. Mills eds. & transls. 1958).

8. See note 73 infra and accompanying text.

9. The security analysts are torn by a struggle over professionalism and the means of regulating behavior. In early 1974, the New York Society of Security Analysts sponsored a proposed draft bill that would have provided for licensing of such analysts by New York State subject to mild qualifications for admission to the practice. See Proposed Professional Security Analysts Draft Bill, February, 1974. Only licensed analysts could publish investment recommendations. The bill was opposed by the Financial Analysts Federation, with a membership of 14,000, the majority of whom are employed by institutions. The Federation has advocated voluntary self-regulation rather than suffer an additional level of bureaucratic control and the probability of divergent state regulatory schemes. See Financial Analysts Federation Plan for Professional Self-Regulation, adopted April 28, 1974, as revised May 10, 1974; Financial Analysts Federation Report to all Member Financial Analysts from Qualifications and Licensing Committee, Re: Professional Standards of Analysts, Feb. 18, 1974. The Financial Analysts Federation plan envisages the establishment of a board to codify standards of behavior and a national conduct committee to punish wrongdoing. Federal regulation may also be in the wings. Garrett, The Security Analysts and the Disclosure Rules (speech before the N.Y. Society of Security Analysts), 171 N.Y.L.J., May 13, 1974, at 1, col. 3 (SEC chairman favors professionalization of the analysts); Gillis, Regulation of Analysts, Financial Analysts J., Jan.-Feb., 1974, at 14; Thomas, Analysts' Insecurity, Barron's, May 27, 1974, at 3, col. 1; BNA Sec. Regs. Rep., Feb. 13, 1974, at A-15, "Professional Groups Take Two Approaches to Regulation of Security Analysts." For discussion on the criteria of professions, see Parsons, Professions, in 12 Encyclopedia of Social Sciences 536-46 (1969); Seeman, Alienation and Engagement, in The Human Meaning of Social Change 467, 520-21 (P. Converse & A. Campbell ed. 1972).

with legal and ethical standards. This development may also hasten the demise of incompetent analysts who seek to rely more on tips than on experience and expertise. A significant number of analysts, our empirical research indicates, pride themselves on their ability to formulate recommendations without taking legally proscribed shortcuts.

II. Overview of Rule 10b-5

Section 10(b),[10] when adopted, was one of the least controversial parts of the Securities Exchange Act of 1934.[11] The rather unheralded promulgation[12] of rule 10b-5[13] by the Securities and Exchange Commission hardly suggested the impact the rule would have in later years. Rule 10b-5 evolved through court and Commission action in four stages: creation of a private remedy, broadened duty of corporate officers, imposition of liability on insiders in connection with securities transactions by themselves and their tippees, and finally, recognition of the tippees as insiders and the devolution of liability upon them. The creation of private civil liability under the rule came about through the ingenuity of members of the bar operating in the private sector. Soon after the initial issuance of the rule, civil suits by persons injured as a result of violations were permitted under the theory that the disregard of an express administrative mandate is a "wrongful act

10. See note 2 supra.

11. 15 U.S.C. §§ 78a-78hh (1970). "It [§ 10(b)] went relatively unnoticed in the major battles over stock exchange regulation, margin rules and broker-dealer segregation, and the less violent struggles over manipulative pools, short-swing insider trading, registration and reporting requirements for listed companies, and the creation of the SEC." 1 A. Bromberg, Securities Law Fraud: SEC Rule 10b-5, § 2.2, at 22.2 (1970) [hereinafter cited as Bromberg].

12. In the words of the late Milton Freeman: "It was one day in the year 1943 [1942], I believe. I was sitting in my office in the S.E.C. building in Philadelphia and I received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, 'I have just been on the telephone with Paul Rowen,' who was then the S.E.C. Regional Administrator in Boston, 'and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at $4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be $2.00 a share for this coming year. Is there anything we can do about it?' So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at [SA] Section 17, and I put them together, and the only discussion we had there was where 'in connection with the purchase or sale' should be, and we decided it should be at the end.

"We called the Commission and got on the calendar, and I don't remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, 'Well,' he said, 'we are against fraud, aren't we?' " Conference on Codification of the Federal Securities Laws, 22 Bus. Law. 793, 922 (1967); see 1 Bromberg § 2.2, at 22.6; Manne, Insider Trading and the Administrative Process, 35 Geo. Wash. L. Rev. 473, 477-78 (1967).

13. 17 C.F.R. § 240.10b-5 (1974); see note 1 supra.

and a tort."[14] Although neither Congress nor the Commission foresaw or proposed such a private remedy, the courts implied the existence of one in the absence of an express legislative prohibition.

Rule 10b-5 was next applied to a faceless securities transaction, and obligations were imposed on a registered representative, who was also a corporate insider, to disclose material information not yet released to the public, prior to trading on the issuer's securities. The "equal access to information" doctrine permitting insiders to use material information only if such information is publicly available was founded on the policy of maintaining public confidence in the fairness of securities markets.[15]

Drawing on this policy, the next logical extension of liability under the rule came about in the landmark decision *SEC v. Texas Gulf Sulphur Co.*[16] In addition to attempting to resolve questions of materiality, adequacy of corporate disclosure, and when insiders may trade after public disclosure, the Second Circuit precluded insiders (tippors) from passing material nonpublic information to corporate outsiders (their tippees) and subjected inside tippors to liability for damages resulting from the trading activities of their respective tippees. Moreover, the dicta in *Texas Gulf Sulphur* has provided the rationale for the subsequent imposition of liability on other tippees.[17]

The ensuing years have witnessed a proliferation of litigation under rule 10b-5 and the spinning of a vast web of confused and often contradictory doctrine in various areas such as standing to sue,[18]

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14. Kardon v. National Gypsum Co., 69 F. Supp. 512, 513 (E.D. Pa. 1946).

15. Cady, Roberts & Co., 40 S.E.C. 907 (1961). In this proceeding the SEC rejected as a defense the common law distinction that officers and executives owe duties only to the corporation itself, not to the shareholders of the corporation. Id. at 913-14. In commenting on the Wall Street reaction to the Cady, Roberts decision, Brooks states: "But so firmly entrenched was the Wall Street tradition of taking unfair advantage of the larger investing public, and so lax the S.E.C.'s administration of that particular part of the law between 1942 and 1961, that not a single stockbroker had ever been prosecuted for improper use of privileged information during those two decades. In the tarpaper shack, 10b-5 had simply been considered too hot to handle. It was the law in name only . . . . [Following the Cady, Roberts decision, it was thought that] [p]resumably the agency would pursue the new policy in the future . . . . [Criticism resulted from the street] [b]ut soon the grumbling died down, and the Stock Exchange turned around and issued a strong set of new directives to its members against the use of inside information by brokers." J. Brooks, The Go-Go Years 86-87 (1973).

16. 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

17. Id. at 852-53.

18. See 2 Bromberg § 8.8, at 221. The cases progressed beginning with Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952), enunciating the purchaser-seller doctrine, through modification in Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971), to Eason v. General Motors Acceptance Corp., 490 F.2d 654 (7th Cir. 1973), cert. denied, 416 U.S. 960 (1974), (noted in 42 Fordham L. Rev. 688 (1974)), rejecting the

materiality,[19] scienter,[20] reliance,[21] causation[22] and tippee liability.[23] The brokerage industry has watched with growing alarm the possible (and inevitable) extension of liability in the tippee situation. The holding in *Investors Management Co.*[24] and the ensuing cases and releases[25] completed the evolution of rule 10b-5 concerning securities

distinction altogether. The Supreme Court has granted certiorari in Manor Drug Stores v. Blue Chip Stamps, 492 F.2d 136 (9th Cir. 1973), cert. granted, 43 U.S.L.W. 3273 (U.S. Nov. 11, 1974) (No. 74-124). Their decision may help resolve some of the confusion regarding the purchaser-seller requirement. See also Whitaker, The Birnbaum Doctrine: An Assessment, 23 Ala. L. Rev. 543 (1971); Comment, The Birnbaum Doctrine—An Aging Rule Reexamined by the Courts, 22 Syracuse L. Rev. 715 (1971); 1974 U. Ill. L.F. 521; 10 Duquesne L. Rev. 692 (1972).

19. 2 Bromberg § 8.3; see SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849, 851 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969) (the reasonable investor test, the market impact test, the "hang yourself test"). For other definitional variations see Affiliated Ute Citizens v. United States, 406 U.S. 128, 154 (1972); Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir. 1970); Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971); Investors Management Co., SEC Securities Exchange Act Release No. 9267 (July 29, 1971), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163. See also Brodsky, Inside Information—Materiality, 169 N.Y.L.J., June 6, 1973, at 1, col. 1; Kripke, Rule 10b-5 Liability and "Material" "Facts", 46 N.Y.U.L. Rev. 1061 (1971). See generally Brodsky, Inside Information—Materiality, 169 N.Y.L.J., June 6, 1973, at 1, col. 1; Part VB infra.

20. 2 Bromberg § 8.4, at 203; see SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854-55 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969) (relaxing rule requiring scienter). See also Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973), noted in 87 Harv. L. Rev. 1066 (1974); Shemtob v. Shearson, Hammill & Co., 448 F.2d 442, 445 (2d Cir. 1971) (indicating that an allegation of negligence alone is insufficient). For recent commentary see generally Epstein, The Scienter Requirement in Actions under Rule 10b-5, 48 N.C.L. Rev. 482 (1970); Note, The Role of Scienter and the Need to Limit Damages in Rule 10b-5 Actions—The Texas Gulf Sulphur Litigation, 59 Ky. L.J. 891 (1971).

21. 2 Bromberg § 8.6, at 209. Recent commentary includes Cobine, Elements of Liability and Actual Damages in Rule 10b-5 Actions, 1972 U. Ill. L.F. 651, 656-67; Dykstra, The Battle Grounds of 10(b)-5, 1971 Utah L. Rev. 297, 305-06; Comment, Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?, 72 Colum. L. Rev. 562 (1972). See also Note, The Reliance Requirement in Private Actions Under SEC Rule 10b-5, 88 Harv. L. Rev. 584 (1975).

22. 2 Bromberg § 8.7, at 213. See generally Bradford, Rule 10b-5: The Search for a Limiting Doctrine, 19 Buffalo L. Rev. 205 (1970); Cobine, Elements of Liability and Actual Damages in Rule 10b-5 Actions, 1972 U. Ill. L.F. 651, 656-67.

23. 1 Bromberg § 7.5(4), at 190.11; Glickman, "Tippee" Liability Under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, 20 U. Kan. L. Rev. 47 (1971); Rapp & Loeb, Tippee Liability and Rule 10b-5, 1971 U. Ill. L.F. 55; Note, Shapiro v. Merrill Lynch, Pierce, Fenner & Smith Inc.: The Tippee of the Rule 10b-5 Iceberg, 5 Rutgers Camden L.J. 256 (1974); see note 25 infra.

24. SEC Securities Exchange Act Release No. 9267 (July 29, 1971), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163.

25. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); see SEC v. Avis, Inc., Civil No. 1065 (S.D.N.Y., filed Mar. 7, 1974); Faberge, Inc., SEC Securities Exchange Act Release No. 10174 (May 25, 1973), [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,378; Bernstein, Disclose or Abstain, 171 N.Y.L.J., Apr. 22, 1974, at 1, col. 1. For background on Faberge and related proceedings see Dorfman, Heard on the Street, Wall St. J., May 2, 1973, at 43, col. 3; id., June 11, 1974, at 2, col. 2. For background on SEC v. Avis, supra,

professionals and inside information, by extending liability to tippees who trade on material nonpublic information. In addition, the now celebrated Equity Funding scandal has spawned an abundance of cases, only recently consolidated for pre-trial proceedings, which may enable courts confronted by a difficult factual situation to unfold further doctrinal developments of interest to the securities professionals.[26]

III. THE ROLE OF THE SECURITY ANALYST IN THE ECONOMIC SYSTEM

Research departments in many brokerage houses, after World War II, were little more than window dressing. The emergence of a highly

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see Wall St. J., Mar. 8, 1974, at 13, col. 3; id., June 7, 1973, at 6, col. 3. See also SEC v. Liggett & Meyers, [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,204 (S.D.N.Y. 1973); Roberts, Scott & Co., Securities Exchange Act Release No. 11013 (Sept. 17, 1974); Reynolds & Co., Securities Exchange Act Release No. 10835 (May 31, 1974), [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,811 (SEC administratively censured three broker-dealers). For background on SEC v. Liggett & Meyers, supra, see Wall St. J., Nov. 5, 1973, at 19, col. 1. See also SEC v. Geon Indus., Inc., 381 F. Supp. 1063 (S.D.N.Y. 1974) (SEC obtained an injunction against a registered representative, but not against the brokerage firm since the firm had established and implemented adequate supervisory procedures); SEC v. Lum's Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973). See generally SEC v. Shapiro, 494 F.2d 1301 (2d Cir. 1974) (corporate "marriage brokers"); SEC v. Celanese Corp., SEC Lit. Release No. 6440 (July 18, 1974) (SEC obtained consent injunction); SEC v. F.L. Salomon & Co., 73 Civ. 3926 (S.D.N.Y. 1973) (complaint noted in [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,146); SEC v. Bausch & Lomb, Inc., Civil No. 2458 (S.D.N.Y. June 4, 1973) (alleging withdrawal of recommendation by brokerage firm after receipt of materially adverse information; the withdrawal of the recommendation deemed equivalent to actual disclosure of information to customer); Hawk Indus., Inc. v. Bausch & Lomb, Inc., 59 F.R.D. 619 (S.D.N.Y. 1973); Brodsky, Liability of Brokerage Firms for Acts of Their Employees, 170 N.Y.L.J., Nov. 5, 1973, at 1, col. 1; Gillis, Bausch & Lomb and Analytic Judgment, Financial Analyst J., May-June 1972, at 10; Wall St. J., June 25, 1973, at 2, col. 2; id., Apr. 3, 1974, at 4, col. 2 (Geon Industries case noted). All of these proceedings were brought by the SEC to enjoin selective dissemination of material nonpublic information to brokerage firms and, ultimately, to their clients.

26. For a compendium of Equity Funding background sources to date of publication, see Herman, Equity Funding, Inside Information, and the Regulators, 21 U.C.L.A.L. Rev. 1 nn. 1 & 2 (1973). See also R. Dirks & L. Gross, The Great Wall Street Scandal (1973); DeMott, Inside Information: The Equity Funding aftermath, Institutional Investor, July, 1973, at 33; Gillis, Equity Funding, Financial Analysts J., July-Aug. 1973, at 8; Goldstein, A Law Professor's Dream, Wall St. J., May 14, 1973, at 30, col. 1; Robertson, Those Daring Young Con Men of Equity Funding, Fortune, Aug. 1973, at 50; Rosenfeld, What Not To Do With Inside Information, 169 N.Y.L.J., June 29, 1973, at 1, col. 1; Seidler, Financial Controls Crooks Have the Edge, N.Y. Times, May 19, 1974, § 3 (Business), at 14, col. 3. See also Equity Funding Corp. Securities Litigation, [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,456 (S.D.N.Y. 1974) (consolidation order for pre-trial proceedings); SEC v. Equity Funding Corp., [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,917 (C.D. Cal. 1973). The Herman article and the Goldstein article both anticipate intriguing legal problems arising with respect to such matters as insider definitions and materiality of rumors.

profitable institutional business, flowing from ever greater domination of the stock market by institutional investors, such as bank trust departments and insurance companies,[27] propelled virtuoso security analysts to positions of power and wealth within particular brokerage firms and on Wall Street generally.[28] In contrast to the flourishing days of the 1960s, the current beleaguered state of the stock market and the resulting impoverishment of the brokerage business (stemming also from negotiated commission rates) has forced many analysts to leave the field or to pursue their trade by working for the institutional investors.[29]

The security analyst currently fulfills three separate functions: (1) descriptive, (2) selective, and (3) critical.[30] Descriptive analysis is limited to the collection of important facts relating to a corporation encompassing the development of new information and the transformation of existing data into a meaningful form for presentation. Advising a brokerage client whether to purchase, sell or hold a given issue—in effect passing judgment on the merits of one stock as against another—is the essence of the analyst's selective role. In performing the function of critic, the analyst may pressure corporations to curb abuses—*e.g.*, the accounting methods which inaccurately reflect financial developments—by threatening to withhold a favorable recommendation.[31]

In order to perform his functions the analyst focuses on assessing and projecting the financial position and earnings picture of a corporation, especially estimating the stock market's appraisal of the future value of corporate earnings. Three major theories presently exist as to the appropriate manner for the prediction of the future price behavior of a security—fundamental, technical and psychological.

The method analysts most widely employ is the evaluation of the so-called fundamentals of a corporation or an industry.[32] This tech-

27. See Solomon, Institutional Investors: Stock Market Impact and Corporate Control, 42 Geo. Wash. L. Rev. 761 (1974).

28. Thomas, Analysts' Insecurity, Barron's, May 27, 1974, at 3, col. 1. The development of the importance and prestige of the security analyst roughly paralleled the increasing torrent of corporate reports and disclosure which supply much of the raw materials for research. See B. Graham, D. Dodd & S. Cottle, Security Analysis 24 (4th ed. 1962).

29. Analysts who work for brokerage firms are called "sell" side analysts; those employed by institutional investors are called "buy" side analysts.

30. B. Graham, D. Dodd & S. Cottle, Security Analysis 25-35 (4th ed. 1962).

31. Id. at 34-35. The analyst's critical function in theory facilitates the development of a "fairer" securities market.

32. The "intrinsic value" theory is an excellent example of the fundamentalist school of thought. The analyst compares certain measures of corporate worth—e.g., book value—with the current market price of the issue. If the analyst finds the market value less than the intrinsic

nique focuses on a dissection of current and projected financial statistics which, analysts believe, provide the key to predicting future securities prices.

The technical analysis, on the other hand, differs markedly from the fundamental approach. The adherents to the technical theory, armed with graphs, charts and more recently with computer print-outs, posit that historic price and/or volume patterns for a corporation, an industry, or the entire stock market, provide the best clue as to the future price behavior.[33] Corporate assets, financial soundness, earnings trends, and other indicia of value, so assiduously assessed by fundamental analysts, are ignored by the technically oriented analyst.

Some theoreticians and a limited number of practicing analysts have espoused a psychological theory which rests on the premise that the value of stock can only be the amount that someone else will pay for it.[34] Rather than evaluating the corporation's financial position or past market performance, the analyst pays attention to stock fads in the hope of getting on and off the investment bandwagon at the appropriate time.

Recently, security analysts and the methods they employ have come under increasing criticism which has questioned the predictability of securities prices, the consistency with which recommendations prove profitable, and ultimately, the economic function performed by analysts. Specifically, the "random walk" hypothesis, that "prices have no memory and yesterday has nothing to do with tomorrow"[35] asks whether an analyst's recommendations, over the long-term, will prove more profitable than the random selection of stocks.[36] Practicing

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value, he has uncovered a bargain. The market price of such security, it is believed, will rise eventually to the "intrinsic value," resulting in gain to those who buy the stock. Conversely, if the market price exceeds the "intrinsic value," the stock should be sold. Cf. R. Badger & P. Coffman, The Complete Guide to Investment Analysis 202-19 (1967); B. Graham, D. Dodd & S. Cottle, Security Analysis 405-15 (4th ed. 1962); H. Levy & M. Sarnat, Investment and Portfolio Analysis 131-78 (1972). See also Moskowitz, The 'Intelligent Investor' at 80, N.Y. Times, May 5, 1974, § 3, at 7, col. 1; Barron's, Sept. 23, 1974, at 7, col. 1.

33. See Schulz, Technician's Perspective, Forbes, May 1, 1974, at 54 (proponent of technical analytical viewpoint).

34. The assumption made by the psychological theory is that it is perfectly all right to pay twice the issue's intrinsic value if at some later time an individual can be found who will pay four times what the stock is worth. "All the smart investor has to do is beat the gun—get in at the very beginning. This theory might less charitably be called the 'greater-fool theory'." B. Malkiel, A Random Walk Down Wall Street 24 (1973). See also J. Keynes, The General Theory of Employment, Interest and Money (1965); G. Le Bon, The Crowd (1908); A. Smith, The Money Game (1968).

35. A. Smith, The Money Game 147-68 (1968).

36. "The theorists say that changes in market prices of securities are like a random walk. Just as a man may turn first in one direction and then in another while walking about with no

analysts are, of course, not oblivious to the "random walk" hypothesis. All analysts interviewed exuded self-confidence combined with a firm belief that skillful analysis leads to more accurate recommendations. The analyst feels that he can achieve superior results over the long-term.[37] It is, however, impossible for all analysts to out-perform the stock market and for this reason there is some validity in the "random walk" hypothesis.[38]

With the small public investor vanishing from the stock market,[39] institutional investors are currently the main customers for the high octane information generated by security analysts. Several astute Wall Street observers noted, in the course of our interviews, that institutional investors look to sell-side (brokerage) analysts to perform the descriptive function—that is, to provide information and put developments in perspective—and place decreasing importance on the stock selection service provided by the analyst. This is a key development in terms of assessing the economic function of the security analyst. Rather than accepting the "random walk" hypothesis and the gloomy conclusions regarding the value of investment analysis, the analyst can emphasize his descriptive role and leave the choice of stocks to the institutional investors and the ever greater number of in-house analysts employed by such enterprises.[40]

particular object in mind, so do stock prices change upward and downward in such manner that the sequence of upturns and downturns cannot be predicted from past price changes They say that the direction of change from one day to another, or from one month to another, is no more predictable than the direction of change in a series of cumulated random numbers." H. Sauvain, Investment Management 165 (4th ed. 1973). See also R. Cootner, The Random Character of Stock Market Prices (1967); B. Malkiel, A Random Walk Down Wall Street (1973); A. Smith, The Money Game 148 (1968); Fama, The Behavior of Stock-Market Prices, 38 J. Bus. U. Chi. 34 (1965).

37. While the theory is that price fluctuations have no relation to informational flow and investigation will be of no substantial assistance in selecting stocks, one firm interviewed had performed research indicating that 70% of price fluctuations were the result of random market activity but that the other 30% was the direct result of corporate developments. These results bolster the philosophy that intensive investigation increases the probability of successful advice.

38. "It is already notorious that the performances of professional money managers exhibit a more and more normal probability distribution. About half of them do better than the averages and about half do worse; and only a small minority perform consistently well over a period of years—probably by chance." Spigelman & Gumperz, New Challenge for Investors: Coping with the Knowledge Revolution, Financial Analysts J., July-Aug. 1972, at 22, 32. See also I. Friend, M. Blume & J. Crockett, Mutual Funds and Other Institutional Investors: A New Perspective (1970); Friend & Vickers, Portfolio Selection and Investment Performance, 20 J. Finance 391 (1965); Thomas, Divide and Multiply, Barron's, Nov. 5, 1973, at 5, col. 1 ("at least half the pension funds do worse than the general stock market averages"). The inability to out-perform the market may lead security analysts to seek material nonpublic information to increase their odds of success.

39. See note 27 supra and accompanying text.

40. The decline in brokerage business forced a number of highly productive analysts to turn

IV. How the Security Analyst Fulfills His Function

The security analyst daily walks a tightwire with respect to rule 10b-5. Despite the advent of the concept of equal access to information for all stock market investors,[41] the analyst, using fundamental methods, attempts to garner slightly more than equal access to improve his performance and provide a greater than equal footing for his clients. The sell-side analyst spends a large portion of his time[42] generating the information necessary to build and refine a model of a corporation by gaining an understanding of the factors which affect, from a fundamentalist viewpoint, the company's earnings and financial position.

The analyst begins first by researching public sources, which include corporate data sent to shareholders, annual or quarterly reports, newspaper and trade publications, and material filed with various public regulatory bodies, especially the Securities and Exchange Commission. Concurrently, or shortly following his review of public sources, the analyst turns to personal meetings and telephone calls with corporate executives. Personal contact allows the analyst to become better acquainted with management and its operation of the corporation, thus enhancing his perception and ability to evaluate the corporation.[43]

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to employment with institutional investors in the hope of greater job security, a more leisurely pace, and freedom from merchandising headaches. Thomas, Analysts' Insecurity, Barron's, May 27, 1974, at 3, col. 3. By employing these analysts institutions are able to pick their own investments. Connelly, The Growing Importance of In-House Research, Institutional Investor, Oct. 1974, at 69; Jansson, There are top analysts at institutions, too. Institutional Investor, Nov. 1973, at 53. More and more leading analysts are branching out on their own, finding themselves in a better position to capitalize on their own talents, and receiving greater financial remuneration than when laboring for a brokerage firm. Dorfman, The rise of the entrepreneurial analyst, Institutional Investor, July 1974, at 43.

41. See note 103 infra.

42. Meetings with institutional clients either alone or with a member of the house's institutional sales force are referred to in the industry as the "road show." One interviewee estimated that 20-25% of that firm's analysts' time was spent on these promotion tours.

43. Seven of the eleven brokerage firms responding on this point indicated that analysts' meetings with corporations constitute an invaluable research tool—indeed, the most valuable. The SEC has also recognized the value of analysts' meetings with corporations. "We also recognize that discussions between corporate management and groups of analysts which provide a forum for filling interstices in analysis, for forming a direct impression of the quality of management, or for testing the meaning of public information, may be of value." SEC Securities Exchange Act Release No. 9267 (July 29, 1971), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,103 at 80,521. In these meetings the analysts were known to seek information not available from public documents or other written sources. Concern was expressed as to the legal liability associated with deficient bases for reports disseminated to clients. To insure their

The analyst, however, does not limit his research to the review of written information and contacts with corporate officers. He also checks sources external to the corporation, such as customers, suppliers, wholesale and retail distributors, and even industry competitors. These sources provide additional data and a means of cross-checking information supplied by the corporation.[44]

Although stressing the need for personal contacts with corporate officials and sources outside the enterprise, brokerage firms manifest a surprising indifference to the development of written or oral policy guidelines regarding the format of these encounters.[45] Apart from the amorphous mandates of rule 10b-5, which are interwoven into operating rules and compliance procedures,[46] the firms in our sample adhere to two basic propositions: that restrictions on format are impractical, and that analysts are professionals who should be allowed maximum flexibility to glean and develop "legally" permissible information. The brokerage industry thus relies on the standards generated by corporations for their own protection with reference to modes of contact between issuers and security analysts.

The disclosure concepts developed under rule 10b-5 and the listing requirements of the New York and American Stock Exchanges increasingly have led corporations to maintain an "open door" policy in their relations with shareholders, security analysts, the press and others who have a legitimate interest in corporate news.[47] This policy stems from a desire to equalize the access to information and to avoid

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continued "peace of mind" and higher standards of accuracy, the analysts cross-check their conclusions by confirmation with the issuer. See Part VD infra.

44. For instance, following the chain of distribution from wholesaler to retailer helps the analyst evaluate product sales and market penetration. Corporate suppliers may assist the analyst in assessing the corporation's abilities to meet production schedules and deadlines.

45. Institutional Investor Systems, Inc., How Major Institutions Deal with the Problem of "Inside Information," A Confidential Report 9 (1973) [hereinafter cited as Institutional Survey]. This report inquired into the frequency with which a number of institutional investors and brokerage firms had set policies for handling the receipt and use of inside information. Only 12% of those responding had no policy, 30% had some unwritten rules (14% some well-defined rules, 16% all well-defined rules), and 58% had written rules. Our response revealed that 11 of the 13 firms had written policies, and the two without written policies believed the unwritten policies of the firm to be well-defined. Twelve of the 13 firms indicated the absence, in their compliance policies, of any guidelines regarding the format of meetings and other personal contacts.

46. Securities professionals were chagrined at their inability to understand clearly the intricacies and application of the rule.

47. See Advertising Dep't, NYSE, Guidelines for Member Firm Communications with the Public (March 1970); AMEX Company Guide, 2 CCH Fed. Sec. L. Rep. ¶ 23,124B (1970); NYSE Company Manual A-20, 2 CCH Fed. Sec. L. Rep. ¶ 23,123 (1971); Letters from Edwin B. Peterson, Jr., Sen. Vice Pres., Compliance & Regulatory Securities Div., AMEX, to Lewis D. Solomon, Apr. 25, 1974 and Aug. 1, 1974.

the appearance of partiality in the dissemination of data. Many corporations, especially those lacking significant institutional support, recognize that the work product of the analyst, especially a favorable report, may assist the corporation in many ways, including the generation of institutional interest in the issue, thereby providing a new source of purchasers. In short, corporations, prodded along by the Securities and Exchange Commission or by their own self-interest, recognize the need for good rapport with security analysts.

Corporations manifest the following three patterns in dealing with securities analysts: (1) refusing any personal contacts with analysts; (2) conducting group meetings with analysts in the presence of the press or followed by a press release at the conclusion of the meeting; or (3) conducting individual meetings with analysts through various corporate officials or designated company spokesmen. In the course of our research, securities professionals indicated that the extension of rule 10b-5 liability generally has not caused corporate officials to be more circumspect in their dealings with analysts.[48] Although the analysts have noted a slight trend toward more group meetings as a means of communicating the corporation's viewpoint while lessening the liability potential under rule 10b-5, the fact remains that most companies continue to meet with analysts on an individual basis. In addition, an interesting paradox regarding disclosure practices may be developing due to the heightened sensitivity of corporations to potential liability under rule 10b-5. Understandably, executives now proceed with more caution, especially with regard to questions which may elicit material nonpublic information. Several analysts in our sample suggested that some managements have used the cloak of "inside information" as the basis for refusing to answer legitimate inquiries, much in the same manner as federal officials have hidden behind the mantle of "national security." Disclosure, if it occurs at all, is restricted to quarterly statements in the form of communications to shareholders and the

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48. While the reluctance to grant personal interviews or take telephone inquiries varies from firm to firm, only two of the 13 houses indicated that the trend toward group sessions curtailed the houses' ability to schedule private meetings. Contrast this with the decision of management at Coca-Cola Co. to close its doors to analysts altogether. Elia, Heard on the Street, Wall St. J., Oct. 3, 1974, at 33, col. 3; Elia, Heard on the Street, id., Dec. 3, 1974, at 45, col. 4 (Coca-Cola will "communicate with or comment to reporters only in the form of press releases"). The presence of the press at group meetings was not greatly desired by the analysts. One respondent reasoned that, with occasional exceptions, members of the press are not prepared and ask elementary and time wasting questions. See also American Soc'y of Corp. Secretaries Release, Suggested Guidelines for Dealing with Financial Analysts and the Investment Community (Mar. 12, 1969); Address by Comm'r Richard B. Smith, U. Chi. Grad. School of Bus., May 8, 1969; Wall St. J., Mar. 31, 1972, at 1, col. 6.

filing of form 10-K.[49] Reticent corporations may thus employ rule 10b-5 to slow the flow of information to investors.

V. ADVISING SECURITIES PROFESSIONALS UNDER RULE 10b-5: INDUSTRY PRACTICES, COMPLIANCE PROCEDURES, AND PREVENTATIVE GUIDELINES

In this section we propose to analyze legal standards and current industry practices in the following areas: (1) conflicts of interest; (2) prohibitions on the use of material nonpublic information; (3) use of the mosaic; (4) confirmation; (5) information barriers between departments; and (6) market impact, and propose practical guidelines for use by counsel and industry sources desirous of avoiding liability under rule 10b-5. The preeminent firms within the industry do attempt to adhere to the legal standards regarding conflicts of interest and the prohibition on the use of material nonpublic information. In the absence of definitive guidelines, analysts rely upon building mosaics, seeking out external sources of information and confirming conclusions with corporate management. Firms differ on erecting walls and generally conduct operations without regard to market impact problems.

A. *Conflicts of Interest: Problems Encountered if Member or Officer of Brokerage Firm Serves on the Board of Directors of an Issuer.*

Brokerage firms no longer may use interlocking positions[50] as a means of obtaining preferred access to material nonpublic matters.[51]

49. The Commission believes that analysts are gratified by the already promulgated improved continuous disclosure requirements for corporations. Garrett, The Security Analysts and Disclosure Rules, 171 N.Y.L.J., May 13, 1974, at 1, col. 3. Self-congratulations are in order for what has already been done, but further action is still needed. See text accompanying notes 100-08 infra. In contrast, analysts have been accused of less than complete candor on occasion, particularly with brokerage clientele. Presumably when an analyst develops data indicating that a once promising investment is no longer desirable, the analyst may merely soften his recommendation rather than change it from buy to sell. Whether or not such an indictment is accurate, it is true that the analyst relies on corporate assistance for information. Analysts may not make too many unfavorable reports for fear that they will be stigmatized by corporations as too critical or negative. In this way, analysts sacrifice integrity for continued good rapport. Several analysts indicated that as a result of this avoidance of negative judgments, Wall Street has devised an elaborate code indicating a "sell" label, recognizable to knowledgeable professionals.

50. By means of an interlocking position a firm is linked to an issuer by placing an employee or partner of the firm on the board of directors of the issuer. At one time this was part of the Wall Street "who do you know" game whereby firms were recognized on the basis of the quality of their inside contacts.

51. Cady, Roberts & Co., 40 S.E.C. 907, 911-13 (1961) (indicating that neither a firm nor its

The duty imposed on a firm member, serving as an outside director, to convey material information to the house's sales force which is recommending the issuer's securities raises additional legal difficulties.[52] In order to comply with existing legal standards, explicit policy guidelines prohibiting members or officers from serving as directors of other corporations, have been promulgated by the firms surveyed. In those occasional instances where firm members do occupy directorships, they are well aware of the risks and consequences of passing along inside information to the firm's clients or salesmen.[53] Increasingly, the practical day-to-day problems encountered by securities professionals involve questions of obtaining and using material nonpublic information by firm members or analysts who do not serve as directors of other corporations, but who gain such information from corporate insiders. This raises the possibility of tippee liability.

B. *Prohibitions on the Use of Material Nonpublic Information in Tippee Context*

1. Material Information

Securities professionals may not trade on or pass along to brokerage clients material nonpublic information.[54] If detected, it results in

employees may engage in transactions with the public, for individual, firm or discretionary accounts, on the basis of material nonpublic data acquired in interlocking positions).

52. Black v. Shearson, Hammill & Co., 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (1st Dist. 1968) (common law recovery where registered representative was director of an issuer and failed to supply material, adverse information in recommending a security to his clients); see text accompanying notes 88-89 infra (ultimate fiduciary duty of the firms).

53. See generally Lanza v. Drexel & Co., 479 F.2d 1277, 1305-06 (2d Cir. 1973) (negligence standard was insufficient to subject an outside director to liability under rule 10b-5; willful or reckless conduct needed); Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 697 (S.D.N.Y. 1968) (underwriters and outside directors, among others, liable under § 11 of the Securities Act of 1933 for a failure to sustain due diligence defenses); Bernstein, The "Outsider" Director and Rule 10b-5, 170 N.Y.L.J., Dec. 26, 1973, at 1, col. 1; Conti, Boardroom Blues, Wall St. J., Sept. 17, 1974, at 1, col. 6.

Forces drawing the leading partners of financial institutions and brokerage firms to directorships of the issuers are the prestige of identification with well-known companies, executives, and other directors, and the opportunity to learn something of value. M. Mace, Directors: Myth and Reality 101 (1971). In firms where members or officers sit on boards of corporations, policies should be instituted requiring such persons to obtain prior approval of senior partners or officers of the firm, not connected with the issuer, before executing any transactions in the issuer's securities. One firm indicated that it placed no restraints on those members seeking to serve as directors, but did supervise recommendations to prospective customers so that no comment was permitted on the shares of interlocked issuers for fear of inside information flowing unchecked.

54. See generally Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); SEC v. Lum's, Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973); Faberge, Inc., SEC Securities Exchange Act Release No. 10174 (May 25, 1973), [1973 Transfer Binder] CCH Fed.

far-reaching liability consequences. The firms in our sample firmly insisted in both questionnaires and interviews that their security analysts do not seek material nonpublic information.[55] In fact, several analysts holding supervisory positions in research departments, stated that the acquisition of inside information serves only to tie the hands of a brokerage house.[56] The major difficulty with inside information is determining when and how inside information becomes material inside information.

Although the decision in *SEC v. Texas Gulf Sulphur Co.* contains three separate tests of materiality,[57] the working concepts of material-

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Sec. L. Rep. ¶ 79,378; Investors Management Co., SEC Securities Exchange Act Release No. 9267 (July 29, 1971), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163; Note, Rule 10b-5: The Effect of the Insider Trading Decisions on the Security Analyst, 54 Minn. L. Rev. 147 (1969).

55. In contrast, one interviewee noted that prior to the decision in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969), analysts were often employed solely to "get the story" on a specific corporation. Many analysts considered it routine to solicit tips regarding significant nonpublic items.

56. Institutional Survey, supra note 45, at 6. ("As for brokerage firms, they were given a rather special, lonely position by the institutions as we worked on this study. To wit, they were made the scapegoat, with a number of institutions saying that most tips emanate from Wall Street and that receiving them has the effect of tying the institution's hands, so the tips do more harm than good.").

57. The court in Texas Gulf Sulphur recognized three tests: (1) The reasonable investor test—"whether a reasonable man would attach importance . . . in determining his choice of action in the transaction in question." 401 F.2d at 849 (emphasis omitted). (2) The market impact test—encompassing "any fact . . . which in reasonable and objective contemplation might affect the value of the corporation's stock or securities." Id. (emphasis omitted). (3) The "hang yourself" test—where a major factor in determining the existence of materiality focused on "the importance attached to the drilling results [in this case] by those who knew about it" and traded on the information. Id. at 851. See Bromberg, Corporate Information: Texas Gulf Sulphur and Its Implications, 22 Sw. L.J. 731, 740-42 (1978). The materiality definitions relied on by the courts stem from common law sources. See Restatement of Torts § 538(2)(a) (1938). The reasonable man test as applied to securities fraud, became the reasonable investor, List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811 (1965), and later the average prudent speculator. SEC v. Texas Gulf Sulphur Co., 401 F.2d at 849-50.

The Supreme Court, in Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972), indicated that the reasonable investor test did not require that the facts, to be material, would have motivated action but only that they be such that a reasonable investor might have considered them important in making his investment decision. See Comment, Affiliated Ute Citizens v. United States—The Supreme Court Speaks on Rule 10b-5, 1973 Utah L. Rev. 119. The SEC's definition of materiality was stated in Investors Management Co., SEC Securities Exchange Act Release No. 9267 (July 29, 1971), [1970-1971 Transfer Binder], CCH Fed. Sec. L. Rep. ¶ 78,163 at 80,521 ("It was of such importance that it could be expected to affect the judgment of investors whether to buy, sell, or hold [the] stock, and if generally known—to affect materially the market price of the stock."). See also SEC v. Shapiro, 494 F.2d 1301 (2d Cir. 1974); Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 569 (E.D.N.Y. 1971); 2 Bromberg § 7.4(3)(h); The Supreme Court 1971 Term, 86 Harv. L. Rev. 1, 268 (1972).

ity currently utilized by brokerage firms focus on the "reasonable investor" standard. Three out of four firms surveyed cited the "reasonable investor" test. Only one quarter relied on the "market impact" definition of materiality.[58]

Although most firms, by now, have developed a definition of materiality,[59] the analyst needs to know in concrete terms what types of information have been and are likely to be held material. The compliance department of one firm compiled the following memorandum of the types of information which it felt a court or the Commission might deem material:[60]

> Dividend increases or decreases, earnings estimates, changes in previously released earnings estimates, significant expansion or curtailment of operations, a significant increase or decline of order, significant merger or acquisition proposals or agreements, significant new products or discoveries, extraordinary borrowing, major litigation, liquidity problems, extraordinary management developments, purchase or sale of substantial assets.
>
> The above list should not be considered exhaustive, but only an aid in recognizing the most common situations that may arise.

Although it is helpful to the analyst, the list does not resolve lingering uncertainties. For example, if a corporation corrects and lowers its announced earnings from one dollar to sixty cents per share, is this material in and of itself? What if the correction was only ten or twenty cents per share? What if the analyst learns through corporate sources that a previously profitable blue-chip corporation will register a minimal quarterly loss due to the acquisition of equipment for expansion?[61] Can the analyst who receives this information know how the reasonable investor would react in a trading situation? Experienced Wall Street hands, cognizant of the severe price declines registered in 1974 by previously high-flying glamour stocks, advise that

58. This test is not favored by analysts because it disregards causality and depends only on hindsight. See Jennings & Smith, Insider Trading and the Analyst, Fifth Annual Institute on Securities Regulation 261, 280 (1974).

59. Only two of the firms indicated that no definition of materiality had been formulated. According to one respondent, since material inside information is difficult enough for the attorneys to define, the analyst cannot be expected to do so. In one firm, supervisory personnel had responsibility for empirically defining materiality by reviewing contacts between its analysts and outside sources. Most firms leave the initial determination regarding material nonpublic information to the security analyst. Only if he perceives a problem are procedures set in motion for intra-firm review.

60. The list is adapted from 3A H. Bloomenthal, Securities and Federal Corporate Law § 9.13 (1974).

61. See Faberge Inc., SEC Securities Exchange Act Release No. 10174 (May 25, 1973), [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,378 (covert disclosure by corporate officer to broker-dealer of material information which inherently influenced investors and the market; and was misused by broker-dealers and investment advisors in violation of rule 10b-5).

almost any hard figures relating to earnings, if provided by corporate insiders, are very likely to be considered material.[62]

To date, litigation has generally concerned instances where, it is believed, reasonable minds would agree that the information was material.[63] What troubles the brokerage industry is that the Securities and Exchange Commission may, in the future, attempt to broaden the definition of materiality to encompass certain "gray areas." If it does, those firms merely complying with current legal standards will be exposed to potential liability in private damage actions.

Verifiable information is a realistic point of focus for the courts and the Commission for preventing securities fraud. However, the Equity Funding proceedings, particularly the New York Stock Exchange charges against Raymond Dirks,[64] focus on the question of whether a rumor could ever be shown to be material nonpublic information. The term rumor suggests unverifiability and it can be argued that even if a rumor has just as fraudulent an effect as any other tip, when the lines of communication are so attenuated between the insider (or other person who propounds the rumor),[65] and the person who hears the rumor,[66] the reasonable investor should not take the rumor seriously.

Wall Street sources questioned provided alternative means of handling rumors. Several analysts indicated that a rumor, even if material, may be treated as public information and employed in their recommendations. The theory is that if a recommendation can be justified by other research performed by the analyst, he should act as though the rumor had simply never come to his attention. Morally and legally this position is unsound. It detracts from the ethical demeanor of the analyst's profession. It also abrogates the obligation, initially

62. SEC v. Avis, Inc., Civil No. 1065 (S.D.N.Y., filed Mar. 7, 1974). Another potentially difficult area is management changes. What happens if the analyst learns that the chief executive position in a corporation will pass to an experienced manager whose credentials include sitting on the boards of several companies which have experienced forced liquidation? If the analyst received notice of the appointment and the appointee's past performance record, all analysts questioned believed this information to be material.

63. See generally 2 Bromberg § 7.4; Herman, Equity Funding, Inside Information, and the Regulators, 21 U.C.L.A.L. Rev. 1 (1973); Jacobs, What is a Misleading Statement or Omission Under Rule 10b-5?, 42 Fordham L. Rev. 243 (1973). The problem areas are the common materiality questions, e.g., knowledge that a corporation is thinking of discontinuing a division; or in light of management's statement as to an earnings increase, an analyst's research reveals that business is slower, and in response to the analyst's queries, management indicates that there will be a slight change in forecast. The analyst may receive inside information which is non-material at the time of receipt, but which, as circumstances change, may become material. Seemingly, the analyst may freely use the information upon receipt.

64. See note 26 supra. See also R. Dirks & L. Gross, The Great Wall Street Scandal (1974)

65. We suggest the "rumoror."

66. We suggest the "rumoree."

imposed upon the corporation and secondarily on member firms under the rules of the New York Stock Exchange, to dispell unfounded rumors which result in unusual market activity or price variations.[67] A firm failing to adhere to this standard faces charges of aiding and abetting corporate violations.[68]

2. Nonpublic Information

Firms may freely use material matter which has been publicly disseminated.[69] This technical distinction has not been universally perceived. Six of the eleven firms replying directly to this question stated that they clearly understood that, in meeting corporate officials, analysts were to inquire only into non-material items. This response indicates that, as a practical matter, these firms have not considered the implications of the public-private material information distinction. Five answers indicated that nonpublic information was a dilemma in itself and that, as a matter of house policy, such data was never actively solicited. Whether these statements regarding nonpublic information resulted from a misunderstanding of the federal securities law prohibitions, or are in accord with the single response which shunned all nonpublic information due to the difficulty of distinguishing "material" from "non-material" data, is not clearly ascertainable.

Eleven of the thirteen firms surveyed stated that they had developed policies to guide the analyst who obtains material nonpublic information. Their policies provide that the analyst initially should advise the firm. The firm then instructs the analyst, and anyone else in the firm to whom he has divulged the inside information, not to pass it on to

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67. NYSE Company Manual A-18 to A-24, 2 CCH Fed. Sec. L. Rep. ¶ 23,123 (1968).

68. 3A H. Bloomenthal, Securities and Federal Corporate Law § 9.12 (1974). See text accompanying notes 64-67 supra for a discussion of a brokerage firm's attempts to make public disclosure, including dispelling rumors.

69. The language of rule 10b-5 has been interpreted to limit liability where adequate public dissemination has been made and the public has had time to absorb the information. See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 853-54 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). In Faberge, Inc., SEC Securities Exchange Act Release No. 10174 (May 25, 1973), [1973 Transfer Binder], CCH Fed. Sec. L. Rep. ¶ 79,378, the Commission stated: "Obviously, what constitutes a reasonable waiting period must be dictated by such surrounding circumstances as the form of dissemination and the complexity of the information, i.e., whether it is 'readily translatable into investment action.' . . . Proper and adequate disclosure of significant corporate developments can only be effected by a public release through the appropriate public media, designed to achieve a broad dissemination to the investing public generally and without favoring any special person or group." Id. at 83,105 (citations omitted). See also NYSE Company Manual A-24 to A-27, 2 CCH Fed. Sec. L. Rep. ¶ 23,123 (1968); AMEX Company Guide §§ 401-06, 2 CCH Fed. Sec. L. Rep. ¶ 23,124 (1970). A problem arises for analysts when dealing with smaller companies having a limited ability to obtain press coverage. Whether regional dissemination is sufficient to satisfy the requirement for public disclosure is not yet clear. See note 100 infra.

anyone else within or without the firm.[70] After sealing off the material nonpublic data, the following four avenues may be pursued: (1) the corporation may be contacted and informed that the firm believes it has inside information and that the company should make a public disclosure; (2) the New York Stock Exchange, the American Stock Exchange or the SEC may be contacted in order to solicit their aid in forcing corporate disclosure; (3) the firm may publicly disclose such information; or (4) the firm may sit on the information and refuse to use it or pass it along to clients. Disclosure by the brokerage firms is not favored by industry representatives because it raises the possibility of incurring liability under rule 10b-5 or of risking libel actions if the information should prove to be false.[71]

In addition to promulgating guidelines regarding the misuse of material nonpublic information, the firms surveyed have taken two other steps: they have instituted both educational programs for research personnel, and review procedures. Compliance people or executives of the firms regularly meet with security analysts regarding inside information. Memoranda are circulated by the firms' compliance departments regarding significant SEC rulings and court decisions. In addition to being routed to research departments, these memos generally go to sales, investment banking and trading areas. Moreover, the firms have established a chain of command and encourage analysts to discuss any problems. These programs take the form of written guidelines. A typical hierarchical review structure might be as follows: (1) initial review by the supervisor of the research department; (2) if the matter cannot be resolved at this level, a partner or officer of the firm is brought in; and (3) finally, the problem may be reviewed by a compliance officer (who is sometimes an attorney), house counsel, or outside counsel.[72] In sum, individuals generally within the firm are designated as persons to whom questions pertaining to the existence and use of material inside information should be referred. When such

70. See notes 24 & 53 supra. No case mandates insider disclosure in the absence of trading. SEC v. Texas Gulf Sulphur Co., 401 F.2d at 850 n.12, leaves the question open. But dicta in Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 519 (10th Cir.), cert. denied, 414 U.S. 874 (1973), indicates that liability may be imposed for non-disclosure if a good business reason does not exist. See Talesnick, Corporate Silence and Rule 10b-5: Does a Publicly Held Corporation Have an Affirmative Obligation to Disclose?, 49 Denver L.J. 369 (1973).

71. The firm also will be liable to traders in the stock who act in reliance upon materially misleading information from the brokerage firm. See note 21 supra.

72. Rigid or formal chains of command are deemphasized in a few firms. The officers and partners in the brokerage firms who handle compliance problems are known to the analysts, and analysts with a rule 10b-5 problem are encouraged to consult the nearest available officer or partner. Perhaps the best type of review would involve input from both business (supervising analysts) and legal sides.

inquiries are in progress, firms restrict the dissemination and utilization of the nonpublic matter. Apparently, fear of tippee liability has resulted in the adoption of such broad preventative and review procedures.

Despite the definitional guidelines and compliance programs, when queried whether violations of perceived standards regarding material nonpublic information have occurred within the firm, which have not resulted in SEC proceedings or civil litigation, interviewees and questionnaire respondents unanimously, as might be anticipated, denied that such infractions have occurred. This comports with the consensus that security analysts do not directly seek tips constituting inside information. Furthermore, no firm admitted the existence of any violations resulting in intra-firm disciplinary actions.

It should be emphasized that the brokerage sources surveyed and interviewed represent the more prestigious segments of the industry. These firms, under the close scrutiny of the SEC, cannot jeopardize their preeminent positions, and the individual analysts employed by them have no desire to risk their own professional stature. Several very responsible Wall Street sources have indicated, however, that a considerable number of security analysts in the smaller, less visible firms still seek inside information. The trading activities of the clients of these lesser known firms might well escape the surveillance procedures of the New York Stock Exchange or the American Stock Exchange.[73] Perhaps reflecting the elitist view of the larger firms,

73. See NYSE Company Manual A-18 to A-24, 2 CCH Fed. Sec. L. Rep. ¶ 23,123 (1968). The stock watch of the New York Stock Exchange is designed to spot unexplained trading patterns, including uncharacteristically large price changes for a listed stock. See Address by Allen B. Witz, Director, Market Surveillance, NYSE, New York Society of Security Analysts, Oct. 23, 1973, in 42 Wall St. Transcript 35,069 (Nov. 19, 1973). A similar procedure is followed by the American Stock Exchange. Amex Stock Watchers Get to the Core of an Issue, American Investor, Aug., 1973, at 4. The SEC has established a permanent task force as part of the Commission's market surveillance unit to investigate cases that may involve insider trading. The task force will work closely with the stock exchange in investigating irregular trading patterns. Wall St. J., Apr. 3, 1974, at 4, col. 2. Factors considered by the SEC Division of Enforcement in initiating enforcement proceedings may include the size of the target firm, the nature of the violation, and the adequacy of the enforcement staff.

A symbiotic relationship existed in the late 1960s between the over-the-counter issuers and these smaller houses. Corporate officials were known to spend considerable time trying to promote their stock and achieve sponsorship. The firms, on the other hand, needed choice information from the corporate executives in order to attract clients. The collapse of the over-the-counter market has made this type of conduct far less relevant. A resurgence of the "hot issue" market may again necessitate scrutiny of relationships between smaller brokerage firms and over-the-counter companies.

The deterrent impact of SEC regulatory actions has come under attack on various fronts. See Herman, Equity Funding, Inside Information and the Regulators, 21 U.C.L.A.L. Rev. 1, 20-26 smaller firms generally are believed to have weaker ethical standards as well as less compliance and preventative machinery. Wall Street traditionally has eschewed bureaucratic structures and organizational charts and this perhaps lends some support to the second charge.

C. *Building the Mosaic: Are External Sources of Information Deemed Insiders?*

In collecting data the analyst gathers information from a variety of sources. He strives to develop pieces of information which in and of themselves are not material, but when taken in conjunction with other information, and inferences flowing therefrom, permit the construction of a so-called "mosaic."[74] The mosaic concept enables the analyst skillfully to perform his job because he has "legally" obtained a conclusion based on his analytical skill and experience, which, if directly tipped to him by a corporate insider, would constitute material nonpublic information.

The mosaic concept, widely used by security analysts, may best be visualized by several examples. The analyst builds his mosaic by looking to sources both internal and external to the corporation. The analyst knows he may not ask an auto executive privately to divulge to him earnings results or projections. Rather, the analyst asks an officer or other corporate spokesman (an internal corporate source) to detail the current demand for the company's products. The analyst knows that if there exists a sales trend toward lower-priced cars, which are less profitable per unit, the corporation's earnings will decline. He will in this manner use his analytical judgment to accomplish indirectly what he could not do directly.

(1973); Sargent, The SEC and the Individual Investor: Restoring His Confidence in the Market, 60 Va. L. Rev. 553, 572-77 (1974).

74. While discussing the Investor's Management Co. case, SEC Commissioner Loomis said the following: "The Commission's idea of a highly specific information is a single concrete event or determination or fact, as opposed to a mosaic of general information, some of which is public and some of which isn't. Skillful assembly of a mosaic may lead an analyst to the conclusion that the company's stock is going to go up or down a point. We are trying not to inhibit securities research. That's one of the reasons why we refer to a specific event rather than the result of research." Loomis on Inside Information, Financial Analysts J., May-June 1972, at 20, 25. See also Gillis, Bausch & Lomb and Analytical Judgment, id., May-June 1972, at 10. The complaint in SEC v. Avis, Inc. Civil No. 1065 (S.D.N.Y., filed Mar. 7, 1974), may appear to negate the mosaic theory. Allegedly, the analyst included information from public sources and nonpublic data from corporate sources. The question, however, is whether the information from the internal sources was material. The mosaic concept presumes that the data from corporate sources is of a non-material nature. One of the dangers in building mosaics and drawing seemingly logical conclusions therefrom is that the mosaic builder may lack sufficient pieces and thereby obtain an incorrect result.

If internal corporate sources prove unhelpful, the analyst may turn to external sources. These outside sources may also serve as a cross-check on data gathered from management. For example, an analyst, aware of a company's development of a new, simpler and faster instant camera, and desirous of predicting its commercial success, might well solicit information from a company official. Three problems exist, however. Revelations by the corporate spokesman as to product acceptance may constitute unusable material nonpublic information. Even if the analyst feels justified in asking and management responds, its response may not be completely candid.[75] Management, in addition, may refuse to comment at all.

The hypothetical analyst may then attempt to create his "mosaic" by developing external sources. He will compare retail with wholesale prices, survey the firm's labor demands, its advertising campaign, and other external indicia of the company's commitment to, and the public's acceptance of, the product. From this mosaic, the analyst will draw his conclusions as to the product's probable commercial success and will make his recommendations to clients.[76]

Responses to interviews and questionnaires indicated that security analysts widely use the mosaic concept in reaching ultimate conclusions. The legal question presented by the use of external sources is whether, for instance, customers or suppliers of the corporation are insiders, thereby rendering the analyst's data prohibited inside information. Ascertaining product sales at one of many retail outlets is distinguishable from eliciting the same information from the company's sole retailer, which may be the equivalent of direct statements by the corporation. Most firms are sensitive to this problem and are beginning to formulate rudimentary guidelines for analysts. A distinct minority feels external sources of any type are fair game. This latter view may place such firms and analysts in a precarious position with respect to rule 10b-5.

Here, as in the area of materiality, whether an outside information source will be deemed an insider may be difficult for the preventative attorney to determine. If the sole supplier case is clear, what if a company purchases 16 percent or 33 percent of its requirements from a given enterprise? We suggest that the more extraordinary the relation-

75. See R. Dirks & L. Gross, The Great Wall Street Scandal 126-34 (1974). Dirks contends the information he received from the corporation itself was not material. Actually, this information consisted of management denials of his independent conclusions. His "mosaic" led him to believe that the corporate denial was unreliable and he passed his recommendation on to his clients.

76. For an interesting account of the plight of the Polaroid Corporation, see Elia, Heard on the Street, Wall St. J., July 3, 1974, at 21, col. 3; id., July 22, 1974, at 11, col. 1.

ship between the corporation and the external source, the more probable the latter will be viewed as an insider.[77] Distance from the corporation makes the information less meaningful and hence usually is less sought after. Even if the analyst avoids clear violations, a gray area enshrouds external sources and poses difficult day-to-day questions.

D. *Confirmation*

While the mosaic concept continues to be proffered by the investment community as an exception to rule 10b-5,[78] analysts, after gathering the basic information about the company from both internal and external sources, commonly seek verification of the data and of the

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77. See the concurring opinion of Commissioner Smith in Investors Management Co., SEC Securities Exchange Act Release No. 9267 (July 29, 1971), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,163, at 80,523 ("The company source is what makes the information 'inside' and the special relationship (as director, employee, consultant, prospective underwriter, etc.) is what creates the duty."). "The Rule does not apply to or prohibit communications with a customer, supplier or competitor even though the information was material to another company, unless an extraordinary, special relationship exists between the two companies, as in the case of a sole supplier." New Guidelines on Inside Information, Financial Analysts J., Jan.-Feb. 1974, at 20, 24. The information possessed by the sole supplier for a company may be synonymous with inside information since that supplier may be the only person who knows it. However, no special relationship exists between competitors and the issuer. This proposed Financial Analysts Federation guideline has been rejected by the New York Society of Security Analysts because it "expand[ed] the definition of insider through the back door in a way that could well foreclose on much valuable public information." Financial Analysts Federation Guidelines as Modified by the New York Society of Security Analysts received with materials from the Financial Analysts Federation, which were submitted to the Securities and Exchange Commission pursuant to Exchange Act Release No. 10316. See note 9 supra. The proposed ALI Fed. Sec. Code § 1303(b) (Tent. Draft No. 2, 1973) defines insider to mean: "(1) the issuer, (2) a director, officer, parent, subsidiary, or sister company of the issuer, (3) a person whose relationship to the issuer gives him access to a fact of special significance about the issuer that is not generally available, or (4) a person who learns such a fact from a person specified in this subsection (including a person specified in this clause) with knowledge that the person from whom he learns the fact is such a person, unless the Commission or a court finds that it would be inequitable, on consideration of the circumstances and the purposes of this Code (including the deterrent effect of liabilities), to treat the person specified in this clause as if he were specified in clause (1), (2), or (3)." See also Loomis on Inside Information, Financial Analyst J., May-June, 1972, at 20, 25. ("If [an analyst], as a result of his examination of all available public information and perhaps conversation with suppliers and customers comes up with this [estimated earnings] information I would say he can use it, provided it's a result of his analysis . . . —it's not something that anybody close to the company has tipped him off to.").

78. "The Rule does not prohibit action resulting from the evaluation of nonpublic information received from an insider, no one part of which is specific, material information, even though such a conclusion if communicated by the company would be material." New Guidelines on Inside Information, Financial Analyst J., Jan.-Feb. 1974, at 20, 23. The New York Society of Security Analysts concurs without reservation. Id.

analysts' conclusions with the company's representatives. In part, the practice has arisen due to the penalties imposed upon analysts for recommending a security without an adequate and reasonable basis. The reasonable investigation requirement charges the analyst with knowledge of reasonably ascertainable adverse information, thereby encouraging him to perform the research as thoroughly as possible. Research reports are checked by qualified supervisory personnel within a brokerage firm to insure that a proper factual basis exists for any conclusions and recommendations and that they are not subject to misinterpretation.[79]

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79. Rules of various securities exchanges require supervisory personnel of brokerage firms to check analysts' reports, including the firm's interest in such security or issuer, past recommendations, and hedge clauses. See, e.g., 2 CCH NYSE Guide ¶ 2472 (1970); SEC Securities Exchange Act Release No. 4593 (Apr. 10, 1951), 2 CCH Fed. Sec. L. Rep. ¶ 25,095.

In complying with the requirement of a reasonable investigation of the security and the issuer, the analyst should obtain certain basic information regarding the security (number of shares outstanding, average trading volume, current price and past price range) and the issuer (business activities, officers, products, assets, financial condition, past and current earnings). See SEC Securities Exchange Act Release No. 9239 (July 1, 1971), 2 CCH Fed. Sec. L. Rep. ¶ 22,760 (must include information regarding management, products, assets, earnings and financial condition). A brokerage firm is deemed to have knowledge of reasonably adverse material information which is reasonably available. The reasonableness of the investigation depends on the speculative nature of the security and the number of customers involved. Hanly v. SEC, 415 F.2d 589, 597 (2d Cir. 1969); see Levine v. SEC, 436 F.2d 88, 90-91 (2d Cir. 1971); Hiller v. SEC, 429 F.2d 856, 857-58 (2d Cir. 1970); Dlugash v. SEC, 373 F.2d 107, 109 (2d Cir. 1967); Floyd Earl O'Gorman, 43 S.E.C. 83, 85-86 (1966); Crow, Brourman & Chatkin, Inc., 42 S.E.C. 938, 943-44 (1966); Hamilton Waters & Co., SEC Securities Exchange Act Release No. 7725 (Oct. 18, 1965), [1964-1965 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,298; Heft, Kahn & Infante, Inc., 41 S.E.C. 379, 383 (1963); Investment Serv. Co., 41 S.E.C. 188, 195-96 (1962); SEC Securities Exchange Act Release No. 6721 (Feb. 2, 1962), 2 CCH Fed. Sec. L. Rep. ¶ 22,759. See generally 1 Bromberg § 5.3; 2 id. § 8.4; E. Weiss, Registration and the Regulation of Brokers and Dealers (1965); Brundy, Origins and Limited Applicability of the 'Reasonable Basis' or 'Know Your Merchandise Doctrine,' in Fourth Annual Institute on Securities Regulation 239 (1973); Jacobs, The Impact of Securities Exchange Rule 10b-5 on Broker-Dealers, 57 Cornell L. Rev. 869, 881-97 (1972); Peloso, The Security Analyst, 7 Rev. Sec. Reg. 873 (Oct. 10, 1974). For a discussion of claims of inadequacy of basis of recommendation by Merrill Lynch of Scientific Control Stock, see In re Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC Securities Exchange Act Release No. 10233 (June 22, 1973), [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,416; Wall St. J., June 25, 1973, at 2, col. 1.

See also Beecher v. Able, 374 F. Supp. 341 (S.D.N.Y. 1974) (estimates of the earnings projections in a prospectus must meet a standard of "high probability of realization"). If the validity of the assumption underlying the projections is in doubt, causing a reasonably prudent investor to be deterred from crediting the forecast, the assumption must be disclosed. Chairman Garrett has found Beecher discouraging and expressed a preference for the lesser standards imposed in Dolgow v. Anderson, 53 F.R.D. 664 (E.D.N.Y. 1971), aff'd, 464 F.2d 437 (2d Cir. 1972) (forecasts should constitute fair and accurate reflection of carefully prepared documents that reflect the best estimates of management and are reasonably believed by them). Address to Financial Analysts Federation by Chairman Garrett (Apr. 29, 1974), [1973-1974 Transfer Binder]

The analysts use confirmation in both mosaic and non-mosaic situations. If, as a result of his mosaic, the analyst concludes that the camera company previously alluded to is experiencing decreasing sales which will result in an earnings downtrend, the analyst may ask the corporation to confirm the magnitude of the earnings drop. At this point, the analyst faces six possible responses: (1) a corporate confirmation; (2) a corporate denial; (3) a corporate refusal to confirm or deny; (4) a vague or ambiguous response; (5) a different (higher or lower) earnings figure than that arrived at by the analyst; or (6) the disclosure by the corporation of information that causes the analyst to modify his conclusion.

Confirmation problems also may arise in non-mosaic instances. For example, a drug firm may publicly announce the delay in construction of a plant in Puerto Rico. The analyst may indicate to corporate executives that earnings will decrease because certain tax benefits will not be available. Upon confirmation of this conclusion, the analyst may lower earnings estimates. Permitting confirmations by the analyst may provide him with the very corporate information denied by the Commission and the courts through more direct routes.

The less adequate the analyst's basis for his conclusion, the less complete the mosaic, and the more it appears that the analyst is improperly soliciting inside data from corporate sources. Applying the converse of the "hang yourself" test of "materiality,"[80] if the analyst will not act on the data collected without confirmation, the Commission or private litigants may argue that the analyst has not completed the mosaic. Furthermore, if the analyst changes his conclusion due to the corporation's denials or its unwillingness to comment on a matter, this may reveal the insufficiency of the research performed by the analyst before seeking confirmation. An unethical management and analyst may stage sham confirmations.[81]

CCH Fed. Sec. L. Rep. ¶ 79,776. Earnings projections in certain industries, e.g., airlines, are probably incapable of meeting the new standard. The standard for earnings projections is probably applicable to estimates by security analysts. See generally SEC Securities Act Release No. 5362 (Feb. 2, 1973), [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,211; Schneider, Financial Projections, 7 Rev. Sec. Reg. 907 (June 25, 1974); Schneider, Nits, Grits, and Soft Information in SEC Filings, 121 U. Pa. L. Rev. 254 (1972); Disclosure of Corporate Forecast to the Investor, Financial Analysts Federation Monograph (Nov. 29, 1972) (Lilley, President of the Financial Analysts Federation); Grant, SEC Hearings on Forecasting Earnings, Smith Barney Research Report (Dec. 7, 1972).

80. See note 57 supra.

81. When a company confirms a conclusion, it may be that the corroboration will merely serve as a sham to permit the analyst to save the expense and time of complying with rule 10b-5. Whether the analyst would truly go to the trouble of building a mosaic if an unfounded guess, presented to a corporate executive as a conclusion, is actually verified by the executive should be

To safeguard against such charges, at the very minimum, brokerage firms should insist that analysts detail the bases for their conclusions before seeking confirmation. This is an area where primary responsibility should rest on the brokerage houses.[82] In addition, to provide some assurance of fair dealing, the analyst should seek verification only of specific conclusions, *e.g.*, a 20 percent drop in quarterly earnings, rather than just a general earnings decline.

Closely allied with the question of confirmation is the practice of analysts of submitting rough drafts of reports to corporate executives and asking for corrections to insure the accuracy of the final product, thus raising the specter of charges that the analyst is in management's control or that management authored the report.[83] This type of involvement must, of course, be avoided. However, it appears permissible for the analyst to submit drafts and for the corporation, dealing at arms-length with the analyst, to ask him to rephrase a statement or indicate that certain information was disclosed to the analyst in confidence and therefore should not be released.

E. *The "Wall"*

Several releases and cases have mandated the erection of a "wall" to separate the investment banking, brokerage and research departments

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considered. The issue raised in the SEC proceeding against Bausch & Lomb, Civil No. 2458 (S.D.N.Y. June 4, 1973), is whether the information involved resulted from a conclusion generated by an analyst's mosaic, management's confirmation of an analyst's conclusion, or information "tipped" by management to an analyst.

82. To place the burden on the corporation to check or screen an analyst's work product before verifying a conclusion is unreasonable. The outside source, if an "extraordinary" relationship exists, may well constitute an insider for the purposes of improper confirmation. See note 77 supra. See also the suggestion of Richard Jennings in Jennings & Smith, supra note 58, at 280 (analyst should advise company that he will release information and if corporation has any questions, it should issue its own press release).

83. The analyst should, wherever possible, avoid a corporate spokesman publicly quoting from a research report in meetings with the press or other analysts for fear it might result in allegations of impropriety. See Report from D. Clurman, Ass't Att'y Gen., Director, Bureau of Sec. & Pub. Financing to Hon. Louis J. Lefkowitz, Att'y Gen. of the State of New York, An Inquiry under Article 23-A General Business Law, into the Offering and Trading of Stock in Levitz Furniture Corporation; Abelson, Up and Down Wall Street, Barron's, Apr. 22, 1974, at 25, col. 5 (stating that an investigation was being initiated by the New York State Attorney General's Office into analysts' relations with corporate executives). "Among other things the probe hopes to uncover the sources analysts use for their information (besides the Wall Street Journal); what brokerage houses expect from their analysts (commissions, maybe?); what supervision they are subject to; what means are used to influence analysts by grubby corporate types (besides calling them by their first name, we expect); the uses to which analysts put information they receive (we can answer that one—they invariably use it to make bad recommendations, but, so far as we know, that's still legal even in New York)." Id. at 26, col. 4.

of brokerage firms.[84] In response to our inquiry to determine what measures had been taken by firms to separate these departments, seven firms stated that a "wall" had been erected to discourage the infiltration of inside information, especially between the investment banking and the research departments. Surprisingly, these policies, where in force, were not embodied in written form. Three firms indicated that no walls existed between research, investment banking and brokerage sections.[85] Two of these houses flatly stated that they believed recent court decisions would make the barrier approach unworkable since information possessed by one area of an organization has been held to be imputed to the firm as a whole.[86] The other firm had established barriers among functional areas but kept department heads aware of material data uncovered by other sectors so that recommendations could be properly supervised. Our research also uncovered close contact and cooperation between the analysts and institutional salesmen within a firm. About half of the responses indicated no concern over the flow of information between the broker-

84. Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC Securities Exchange Act Release No. 8459 (Nov. 25, 1968), [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,629 (consent decree entered into arising out of dissemination of insider information received by virtue of its position as underwriter for Douglas Aircraft. The settlement the SEC obtained from Merrill Lynch included a Statement of Policy (Exhibit A to the Release) that inside information obtained by the underwriting department of the firm would be sealed in such department and not released to anyone outside the department, subject to certain exceptions); Investors Management Co., SEC Securities Exchange Act Release No. 9267 (July 29, 1971), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,163. In Investors Management Co., the Commission stated, "We consider it appropriate to observe that in future cases we would view as suspect and subject to close scrutiny a defense that there was no internal communication of material non-public information and its source by a member of a broker-dealer firm or other investment organization who received it, where a transaction of the kind indicated by it was effected by his organization immediately or closely thereafter. A showing of such receipt and transaction prior to the time the information became public should in itself constitute strong evidence of knowledge by the one who effected the transaction and by the firm." Id. at 80,522 n.28. See also Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir.), cert. denied, 414 U.S. 874 (1973).

85. Interviews with smaller firms illustrated the difficulty such houses faced in maintaining a "wall" since a single individual may function in several areas. In addition, some firms recognized a need for close relationships between various departments, which makes formal policy difficult to enforce. Except for crisis situations, these firms indicated that general information passed between or among various departments. See also Herman & Safanda, The Commercial Bank Trust Department and the "Wall," 14 B.C. Ind. & Com. L. Rev. 21, 37 (1972).

86. An obvious reference to Slade v. Shearson, Hammill & Co., [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,329 (S.D.N.Y. 1974), certification granted, [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,439 (S.D.N.Y. Mar. 18, 1974), remanded for further findings of fact, [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,914 (2d Cir., Dec. 16, 1974); see Bernstein, Beyond Texas Gulf, 169 N.Y.L.J., Jan. 28, 1974, at 1, col. 1; 27 Vand. L. Rev 815 (1974); Wall St. J., Sept. 16, 1974, at 1, col. 6.

age and research departments.[87] Only several questionnaires and interviewees stated that an informal policy existed regarding the placement of a barrier between research and brokerage departments. The key point overlooked by the firms surveyed is the need, if an analyst comes into possession of material nonpublic information, to contain such information within the research department until the house decides how to handle the situation. Firms must develop an increased sensitivity to this problem.

The impact of *Slade v. Shearson, Hammill & Co.*[88] may lead to the abandonment of walls erected as part of compliance programs of brokerage houses operating in more than one functional area. The practical problem presented by the case can be illustrated simply. The research arm of a firm has for some time issued favorable recommendations regarding a corporation. The investment banking department of the firm in performing services for such issuer—for instance, underwriting or private placement—ascertains material adverse information of a nonpublic nature. In light of *Slade,* the firm's research department must cease recommending the stock as well as abstain from trading for its own account or making a market in the issuer's securities. Stated differently, where a brokerage firm acts in more than one functional area, its research staff may only prepare and disseminate written factual reports without any comments, conclusions or recommendations. On the brokerage side, registered representatives in such situations must also be advised not to comment on or recommend the stock. If the investment banking department possesses inside information, several difficult situations from the viewpoint of salesmen and clients ensue. A customer who does not hold the security may call

87. The situation is exacerbated by house policies making analyst advancement dependent not only on the good will of senior analysts and supervisors of the research department, but also on the good will of the firm's institutional salesmen who generate the life-blood of the firm—brokerage commissions. The firms emphasize, as a selling point, the availability of their analysts to discuss with institutional clients the analysts' views regarding an issuer. An analyst learns that promotions come faster and easier (or at least job security is maintained) if he provides the salesmen and key institutional clients with subtle shifts in the analyst's opinions and changes in conclusions. In this environment, the potential and the motivation for tipping of inside information or conveying market information does exist.

88. [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,329 (S.D.N.Y. 1974), certification granted, [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,439 (S.D.N.Y. Mar. 18, 1974), remanded for further findings of fact, [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,914 (2d Cir., Dec. 16, 1974); Black v. Shearson, Hammill & Co., 266 Cal. App. 2d 362, 72 Cal. Rptr. 157 (1st Dist. 1968). See also Poser & Aronson, Conflicts of Duty, 2 Rev. Sec. Reg. 825 (1969); Poser, American Stock Exchange Information Circular No. 28-71 (Mar. 8, 1971); Jacobs, The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers, 57 Cornell L. Rev. 869, 971 (1972). See generally Lipton, Rule 10b-5: The End of Isolation and New Thresholds of Materiality, Sixth Annual Institute on Securities Regulation 326-45 (1974); Note, Conflicting Duties of Brokerage Firms, 88 Harv. L. Rev. 396 (1974).

a salesman and elicit his opinion on the issue. The registered representative is not free to comment on the security. The customer then buys the stock, which drops precipitously. The firm faces a possible suit from a disgruntled customer. On the other hand, a registered representative may have previously advised a client to buy the stock. The client subsequently calls and the representative advises him he can no longer comment on the stock (again the investment banking department is privy to materially adverse inside information but the registered representative suspects that the issuer is in trouble and probably wishes to get his customers out of the stock). The issue plummets, exposing the firm to liability, even in the absence of trading by the customer, for failure to make full disclosure to its customers.[89] In short, how should the brokerage firm handle clients in the face of the house's knowledge of materially adverse inside information?

Brokerage firms may handle the problem in at least four possible ways. First, supervisory personnel may keep abreast of material data known to other functional areas, so that recommendations by the research and brokerage sides are properly supervised. If a firm's investment banking department ascertains material nonpublic information, the data should be sealed in such department and the firm's research and brokerage sides should abstain from making any recommendation regarding the issuer's securities. The easier course is for a firm to place a security on a restricted list and withdraw a recommendation when the house enters into an investment banking relationship with a corporation (and prior to the receipt of any material nonpublic information) and thereafter, throughout the duration of the investment banking relationship, to make no further recommendations and prohibit its registered representatives from recommending the security. The withdrawal of the recommendation at this point probably may be

89. A narrow reading of the tippee cases makes this argument appear invalid. No financial advisor is permitted to correct earlier recommendations, true when made, but now misleading, when the only means of correction is to tip inside information of a material nature. See notes 22-24 supra. The firm owes a duty to its investment banking clients to preserve the confidentiality of material nonpublic information disclosed to it. Schein v. Chasen, 478 F.2d 817, 823-24 (2d Cir. 1973), vacated and remanded on other grounds sub nom. Lehman Bros. v. Schein, 416 U.S. 386 (1974). Withdrawal of a recommendation, after receipt of materially adverse inside information, may expose a firm to liability to both its investment banking client and its brokerage clients. See the complaint brought by SEC against Bausch & Lomb, Inc., Civil No. 2458 (S.D.N.Y. June 4, 1973).

Eventually, as in the case of softened recommendations (see note 49 supra), a refusal to comment will become recognized as a "pat phrase" admission of the possession of material nonpublic information. Whether or not the firm has an advisory relationship with its customer, the house cannot disclose the inside information. If the recommendation is changed to be consistent with the inside information, the firm engages in tipping. If the firm continues to make recommendations contrary to the inside information secured by its investment department, liability ensues under the Slade decision.

accomplished without creating any inferences regarding the receipt of material nonpublic information of a positive or adverse nature. This course enables the firm to perform its brokerage functions even if the investment banking department has material nonpublic information. However, the firm, after the establishment of the investment banking relationship, but prior to the receipt of material nonpublic information, may continue to disseminate recommendations. When the firm's investment banking department secures material nonpublic information, the firm may cease making recommendations, but continue to execute brokerage transactions in the issuer's securities. This latter course, however, poses the problem, considered above, of exposure to suits by clients stemming from the withdrawal of the recommendation and the refusal of the salesman to comment. Secondly, the firm might pressure the issuer to disclose the information. However, corporations may not desire speedy public dissemination of materially adverse information. Thirdly, the brokerage firm itself might make the disclosure, thus presenting a difficult liability question with reference to the firm's fiduciary duties to the issuer. Finally, if the brokerage department is executing transactions while the investment banking side is also serving the corporation, the firm might choose to perform only one of the functions. Although cutting the firm's revenue sources, this course appears to solve the problems regarding conflicting fiduciary obligations and possible violations of rule 10b-5. The financial difficulties faced by the brokerage industry, perhaps, renders the first alternative (that is, placing a security on a restricted list and withdrawing any recommendation and preventing further recommendations when the firm enters into an investment banking relationship) the most suitable for firms in need of income streams from both the investment banking and brokerage sides.

F. *Market Impact*

Firms having a major market position or expertise in relation to an industry, or even one company, face a final problem—namely, the impact of information which may have a material effect on the market for and the price of a security, but which does not emanate from the issuer.[90] Wall Street sources stated that market impact problems

90. The initial Commission proceeding based on market information was brought against Sorg Printing Co., SEC v. Sorg Printing Co., [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,767 (S.D.N.Y. Aug. 21, 1974); Wall St. J., May 22, 1974, at 9, col. 2; see Financial Columnist Agrees to Injunction Against "Further" Securities Violations, id., Oct. 24, 1974, at 8, col. 3 (injunction by SEC against Alex N. Campbell. Action alleged fraud based on market information). See also SEC v. Campbell, [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,580 (C.D. Cal. 1972). A private suit, Birdman v. Electro-Catheter Corp., 352 F. Supp. 1271 (E.D.

encountered by securities professionals[91] can best be viewed on three levels: the analyst's response to institutional investor questions while he is in the process of his factual inquiry and preparation of his report; methods of disseminating the final research product; and the handling of block positioning. Concern must be focused on forces generated by securities professionals which may produce a price impact.[92]

The market impact question flows out of the overwhelming reliance of the leading brokerage firms on institutional customers, which are cultivated assiduously in part by making such clients feel that they can freely contact analysts to discuss specific securities they follow or general market trends. The institutional client may simply ask the analyst about recent developments in general; ask about a corporation generally or about a specific development; or solicit information regarding a report the analyst is preparing on a corporation. The analyst may respond to such inquiries in a variety of ways. Queries regarding earnings may result in the analyst's giving his opinion about earnings, subject to the qualification that he plans to confirm his figures with the company. As the analyst's report proceeds to completion, the analyst may admit that he is preparing a report and convey his preliminary conclusion. Although the leading firms increasingly are sensitive to the

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Pa. 1973), held that the defendant had an obligation to disclose in the future market impact information, if material. Failure to do so would thwart the basic policy of rule 10b-5. The rationale for the parity of information standard is that the effect to the investing public is the same whether the issuer's shares decline in price as a result of misuse of inside corporate information or decline in price as a result of general market information. See Lipton, Market Information, Fifth Annual Institute on Securities Regulations 287, 290-97 (1974); ALI Fed. Sec. Code § 1303, Comment (2) (Tent. Draft No. 2, 1973). The following statement by the chief trial counsel, N.Y. Regional Office, Securities and Exchange Commission, summarizes the reasoning behind the market impact concept: "Conceptually, therefore, section 10(b) should apply whenever any person trades on or disseminates information which is material to an investment decision and is not public but should be, or is about to be. The character of the information . . . about a corporation's financial statements, its operations or future plans, should be relevant only as to its materiality. There need be no requirement, however, that the information acted upon or disseminated, have concerned these matters. Indeed, there should be no requirement that it even emanates from within the issuer as long as the information can be reasonably calculated to affect the market price of the security traded." Peloso, SEC Rule 10b-5 and Outside Information, 168 N.Y.L.J., Dec. 11, 1972, at 32, col. 3. Analysis of market information will involve the SEC and the courts in questions of materiality based on the reputation of analysts. See also Elia, "Heard on the Street," Wall St. J., May 31, 1974, at 31, col. 3 (market impact of unfavorable research reports by prominent institutionally oriented brokerage firms).

91. For analytical precision assume the analyst's information comes only from public sources and neither the analyst nor the firm undertakes transactions for his or its own account on the basis of such information.

92. Numerous other market impact problems of concern to analysts may occur, e.g., when the brokerage firm establishes its own market position before publication of its report, or changes prior recommendations. See Fleischer, Mundheim & Murphy, An Initial Inquiry into the Responsibility to Disclose Market Information, 121 U. Pa. L. Rev. 798, 800-02 (1973)

problem of selective dissemination to institutional clients of information or opinions of analysts, these factual patterns constitute daily occurrences within the brokerage industry.

The following practical guidelines are suggested to handle such problems. If the institution calls prior to the analyst's having made the confirmation, the analyst should indicate he can only comment after such verification. Upon confirmation, if the matter is non-material, the analyst might respond to inquiries. If it is material, but the firm does not wish to make public dissemination, the analyst should avoid disclosure of his conclusion to the client. It also is recommended that the analyst not disclose preliminary research findings until the report is in final form and ready for distribution through normal channels.[93]

As research reports may trigger price changes in an issuer's security, the means of disseminating such reports are critical. Ideally, the broker should deal fairly with all customers.[94] Firms with branch offices state that they simultaneously send the substance of a recommendation by wire to all offices with instructions to divulge the conclusion to all salesmen, both institutional and retail, at the same time. Within the firm, this procedure avoids the problems of simultaneous telephone calls and postal delays. However, firms stated that institutional salesmen contact clients in order of their relative economic importance. In an era of negotiated commission rates, perhaps customers paying a higher price for deluxe services should receive preferential treatment in the dissemination of information. To avoid potential liabilities, it may prove safer for the firm to instruct salesmen to rotate the order in which they contact institutional clients so as to avoid favoritism.[95]

93. Market information problems lie on the frontiers of rule 10b-5 calling for doctrinal developments to elucidate the issues further. See Courtland v. Walston & Co., 340 F. Supp. 1076 (S.D.N.Y. 1972) (dissemination of market letters successfully attacked).

94. Recommendations should be disseminated in a manner which will be consistent with the broker-dealer's obligation to deal fairly with all its customers. Butcher & Sherrerd, SEC Securities Exchange Act Release No. 9894 (Dec. 11, 1972), [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,135. See also Merrill Lynch, Pierce, Fenner & Smith, Inc., SEC Securities Exchange Act Release No. 8459 (Nov. 25, 1968), [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,629; Fleischer, Mundheim & Murphy, An Initial Inquiry into the Responsibility to Disclose Market Information, 121 U. Pa. L. Rev. 798, 835-40 (1973). Dissemination requirements relate to the substance of the recommendation and not to the amount of underlying detail provided with it, because various types and classes of investors may want or require differing amounts of detail. See Fleischer, Mundheim & Murphy, Disclosure of Investment Advice, 6 Rev. Sec. Reg. 867 (1973). Firms should maintain safeguards to prevent leakage of reports before official distribution. Wall St. J., July 6, 1973, at 7, col. 1.

95. However, no case suggests that each client must be informed of every recommendation in the same way. See Fleischer, Mundheim & Murphy, Disclosure of Investment Advice, 6 Rev. Sec. Reg. 867, 871 n.21 & 22 (1973). See also Wall St. J., July 6, 1973, at 7, col. 1 (leakage of analyst report prior to official distribution).

Block positioning presents a final difficult area regarding market impact. Registered block positioners are member firms who facilitate client transactions by taking for the firm's account all or any portion of a block which cannot otherwise be disposed of.[96] In undertaking such transactions, the firm usually values the block of shares at a discount below current market price. When the firm then approaches a prospective institutional purchaser, it discloses the existence of such an overhanging block and the price discount. The firm and such institutions contacted thus possess material market information resulting from the knowledge of supply and demand forces.[97]

The rules of the New York Stock Exchange designate certain persons who may not personally benefit from information involving a trade of 5000 or more shares.[98] Exceptions are prescribed, however, to facilitate other transactions and to serve the public. The Commission and the New York Stock Exchange have not eliminated the informational advantages of block positioners, specifically relating to supply and demand, which accrue from their very function and location in the securities market.[99] In light of this policy, which appears soundly based, firms should continue present block positioning practices.

VI. REFORM

The basic disclosure policies of rule 10b-5 are founded on the principle that parties to securities transactions should have equal access to information.[100] This contributes to public confidence in the securities markets by attempting to insure that all investors receive fair treatment. Honest conduct in the market, it is hoped, will promote the economic good of the nation. The extension of liability to tippees flows

96. A similar problem exists for market-makers. See Fleischer, Mundheim & Murphy, Disclosure of Investment Advice, 6 Rev. Sec. Reg. 867, 869 (1973).

97. Lipton, Market Information, Fifth Annual Institute on Securities Regulations 217, 242-44 (1973). Additional problems exist with regard to disclosure of the block positioner's inventory and future price intentions, and disclosure of the block positioner's knowledge of other investor's intentions.

98. See NYSE Rule 112.10(b), 2 CCH NYSE Guide ¶ 2112.10 (1972).

99. See Report of ABA Subcommittee on Rule 10b-5 and Subcommittee on Broker-Dealer Matters to the SEC, BNA Sec. Reg. Rep. No. 233, at D-1 to D-6 (Jan. 2, 1974) [hereinafter cited as ABA Report]. See also Fleischer, Mundheim & Murphy, An Initial Inquiry into the Responsibility to Disclose Market Information, 121 U. Pa. L. Rev. 798, 847-58 (1973). However, if market information need only be disclosed when a special relationship between the parties creates an independent duty to disclose (see Landy v. FDIC, 486 F.2d 139 (3d Cir. 1973), cert. denied, 416 U.S. 960 (1974); remarks of Stanley Sporkin, Fifth Annual Institute on Securities Regulation 303-04 (1973), does not knowledge, for instance, of the overhanging block constitute a special relationship? If such information "gets out" to other firms such a relationship may no longer exist.

100. See 3 Bromberg § 12.2; note 103 infra.

from a desire to bolster the expectation of confidentiality acquired from various relationships with issuer corporations.[101] Despite the unanimous acceptance of this rationale by the Commission and the courts, should the entire policy basis underpinning rule 10b-5 be reevaluated? The economist postulates that an efficient stock market should quickly reflect changes in corporate conditions.[102] The flow of information from the corporation to the market produces prompt price adjustments in response to corporate developments. In a soundly functioning market a minimum number of trades should exist between price adjustments.

It might be argued that permitting the analyst to receive material nonpublic information from corporate sources and pass it on might serve the public interest. For instance, information regarding fraud or mismanagement, if conveyed by the analyst to his clients, facilitates price changes in light of such developments. If a company plans to make such disclosure in two weeks, but the analyst obtains the data now which is then acted on by his clients, the price adjustment process is hastened. Otherwise, such information will not be reflected in the price for two weeks, thereby causing the public to pay inflated prices not accurately reflecting corporate developments. Such a system would additionally promote an incentive for the diligent analyst. The ability to obtain inside information would be rewarded handsomely by commissions accruing to the analyst's firm. If the analyst cannot use this inside information, he may not be as diligent in his search.[103]

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101. ABA Report.

102. See generally, W. Baumol, The Stock Market and Economic Efficiency (1965); Economic Policy and Regulation of Corporate Securities (H. Manne ed. 1969); Benston, Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934, 63 Am. Eco. Rev. 132, 137 (1973); Kassouf, Towards a Legal Framework for Efficiency and Equity in the Securities Markets, 25 Hastings L.J. 417 (1974); Robbins & Werner, Professor Stigler Revisited, 37 J. Bus. 406 (1964); Stigler, Public Regulation of the Securities Markets, 37 J. Bus. 117 (1964).

103. The policy reasons of developing a "fairness" standard based on the need for incentives are weighty. "Analytically such a fairness approach reflects an attempt to balance at least two considerations which are central to regulation of securities markets. The securities law seeks to foster public investment by promoting confidence in the securities markets. Elimination of disparities in information available to participants in the trading markets has been an important part of the program to maintain public confidence. At the same time the federal securities laws also seek to enhance the efficiency of the securities markets as an allocator of resources. Prompt disclosure is important to that aim. In addition, sufficient incentives must exist to encourage the digging out of information and careful and imaginative analyses of the available information." Fleischer, Mundheim & Murphy, Disclosure of Investment Advice, 6 Rev. Sec. Reg. 807, 809-19 (1973). See also Lipton, Market Information, Fifth Annual Institute on Securities Regulations 217, 220 (1973) (indicating the trend toward parity of information ultimately will

This is, however, not a novel argument.[104] In evaluating the trade-off between fairness, on the one hand, and the most efficiently functioning stock market and entrepreneurial rewards on the other, the balance has been struck in favor of equal access. It seems likely that the Commission and courts will continue to adhere to such a position. However, despite attempts to equalize access to information, it should be noted that clients of different firms have varying informational positions relative to the analytic skill and judgment of the research department and its resources.[105]

The Commission should promulgate guidelines confirming sound industry practices and clarifying uncertainties. Areas of specific concern suitable for such standards include: contacts by analysts with corporations, mosaics and verification. First, the Commission should sanction direct contacts between analysts and corporate management to obtain non-material information.[106] Although these encounters would increase the likelihood that inside information may pass to analysts, it is hoped that these contacts would provide additional data upon which the analysts could exercise their investment skills.

Secondly, the Commission should explicitly permit the building of mosaics. The security analyst, exercising judgment and expertise, accumulates information so as to develop a model of the company. His

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emerge as the legal standard). One Wall Street professional characterized the trend for economic egalitarianism in terms of "to each according to his need, from each according to his ability."

104. Essentially the theory is founded on the premise that entrepreneurs and quality executives should be rewarded through recourse to insider trading. See H. Manne, Insider Trading and the Stock Market (1966); Manne, Insider Trading and the Law Professors, 23 Vand. L. Rev 547 & n.2 (1970).

105. Although securities professionals might like the public and regulators to believe that compliance with rule 10b-5 is unnecessarily costly, the contrary is probably true Two firms estimated their costs approached $40,000 and $50,000, respectively. Most houses could not give estimates, but discussed factors they would consider in arriving at such a figure, including legal expenses, attorney's fees, supervisory personnel, as well as the time involved for all personnel to keep abreast of changes in the law. One interviewee suggested that the real cost of compliance couched in this framework was nearly nothing. Compliance personnel would be necessary in any house to delineate the scope of the regulatory framework, and rule 10b-5 would be just another area on a compliance staff's agenda. A real cost generally not computed by brokerage firms is the commission volume that could be generated if inside information could be conveyed to customers, especially institutional investors.

106. New Guidelines on Inside Information, Financial Analyst J., Jan.-Feb 1974, at 20 Especially note both former Chairman Casey's and former Chairman Cook's comments at 23 Presently many larger companies have officers whose only job is to meet with analysts and answer their questions. This contact would hardly provide as good a "feel" for the operation of management affairs as would a meeting with those who actually formulate policy and make decisions.

analysis culminates in an ultimate conclusion which is then disseminated to clients,[107] thus permitting the price of an issuer's securities to more accurately reflect corporate developments. Analysts should be permitted to construct and cross-check mosaics by contacting sources both internal and external to the corporation.

Thirdly, the Commission should sanction the analysts' confirming their conclusions with corporate management. To avoid sham verification situations, supervisory personnel of brokerage houses should be responsible for reviewing analysts' work products prior to corporate confirmation. Guidelines might also be generated as to the types of items analysts generally should include in a mosaic before attempting verification.[108]

Additional study must be undertaken before the Commission promulgates standards regarding the multitude of market impact problems, and the flow of information between different departments in a firm serving an issuer and at the same time recommending securities of such corporation to customers. In view of the brokerage industry's current struggle for survival, rules which effectively force the splitting of firms into separate entities with distinctly different functions seem economically unsound. The industry argues that the legal standards developed in the *Slade* decision[109] may place certain firms at a competitive disadvantage because clients may perceive a house as incompetent when it is unable to express recommendations in certain situations. An additional question raised is whether the firm owes its ultimate fiduciary obligation, in such instances, to its customers or the issuer which it also serves.[110]

Attempting to delineate guidelines for materiality and to classify

107. The SEC could devise guidelines to assure that information is rotated to different clients within the class seeking that type of information. See note 94 supra.

108. We conclude that sound policy reasons exist for the imposition of liability on broker-dealers who make recommendations based upon insufficient information. See note 79 supra. But note the opposite position of Stanley Sporkin, Fifth Annual Institute on Securities Regulation 277-78 (1973) ("What is the difference between a company not raising by red flags on an analyst's projection of $1.80 per share and the company telling the analyst that the earnings are going to be $1.80? I don't think the fact that somebody did a little bit of homework means that he should be able to go to management and say: 'We have come in Mr. President, with $1.80. Are we in the ballpark?' It seems to me that the response he is getting in [sic] material information and he is therefore precluded from trading."

109. Slade v. Shearson, Hammill & Co., [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,329 (S.D.N.Y. 1974), certification granted, [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,439 (S.D.N.Y. Mar. 18, 1974), remanded for further findings of fact, [Current Binder] CCH Fed. Sec. L. Rep. ¶ 94,914 (2d Cir. Dec. 16, 1974).

110. See note 89 supra. See also ALI Fed. Sec. Code § 1303(b)(4), Comment 67(b) (Tent. Draft No. 2, 1973).

sources of information external to the corporation which fall within the extraordinary relationship definition of an insider appear to be exercises in futility for even the most able scholars[111] and a waste of the Commission's time and money. Definitive determinations of materiality and extraordinary relationships must be rendered on an ad hoc basis. What is material is subject to and varies with time and a variety of factors among industries and corporations. The Commission could mandate that the analyst may not contact a corporation's sole supplier or customer. In addition, it could select an arbitrary cut-off figure, permitting the analyst to contact suppliers if more than five in number. However, one supplier might occupy a preeminent position and another might provide a critical product or material, thus making such a numbers game a palliative of little permanent value.

Apart from changes in verbal formulations and the development of more precise guidelines, we recommend a twofold program: increased pressure for more corporate disclosure and the establishment of a no-action telephone system by the Securities and Exchange Commission. The analyst feels the weight of the Commission because of its regulatory jurisdiction over broker-dealers under the Securities Exchange Act of 1934.[112] The Commission can reach security analysts more easily than corporations and their executives in trying to solve the inside information problem. Following the disclosure guidelines of the New York Stock Exchange[113] we suggest that the Securities and

111. See ALI Fed. Sec. Code § 256 (Tent. Draft No. 2, 1973). This section is devoid of specifics. If so eminent a scholar as Professor Louis Loss can do no more than deal in generalities, it is unlikely any written standards can be devised to seriously guide action in the "gray areas." See Painter, Rule 10b-5: The Recodification Thicket, 45 St. John's L. Rev. 699 (1971). Regarding the definition of "insider" see remarks by Stanley Sporkin, in Fifth Annual Institute on Securities Regulation 267 (1973). "For that reason, I would certainly think it possible to find a theory under which information obtained from suppliers or distributors would be included in 'inside information.' If information cannot be obtained directly from the company, I do not see how it becomes acceptable to go to 50 distributors and get the same kind of information. I simply do not believe that that concept is going to fly."

112. See generally E. Weiss, Registration and Regulation of Brokers and Dealers (1965).

113. See text accompanying notes 47-49 supra."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." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 850 n.12 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969). See also SEC Securities Exchange Act Release No. 5092 (Oct. 15, 1970), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,915 (Commission reiterated the need for publicly held companies to make prompt and accurate disclosure of information, both favorable and unfavorable, to security holders and the investing public). But see Feuerstein, The Corporation's Obligations of Disclosure Under the Federal Securities Laws When It Is Not Trading in Its

Exchange Commission mandate prompt and continuous disclosure of all material corporate information, even in the absence of any insider or tippee transactions. This proposal should be contrasted with current management disclosure procedures which in many cases may prove inadequate or incomplete. An example of quarterly disclosure illustrates the problem. At the beginning of a quarterly period, management, as part of its regular program of public quarterly dissemination, states that earnings are projected to rise by ten percent during such time frame. At the conclusion of the quarter, management announces that earnings, in fact, declined 25 percent. During the quarter, a certain event or events occurred rendering the forecast inaccurate. Rather than waiting to the end of such period, management, after proper verification, should publicly state that business is not progressing as well as had been anticipated, the forecast will not be met, and the reasons therefor.

Continuous corporate disclosure would assist the analyst and remove part of the temptation to seek inside information. Such dissemination would promote a more efficient stock market by producing more accurate responses to events actually occurring within the corporation.[114]

Even if the Commission were to clarify questions regarding corporate contacts, and mosaic, and verification, the application of these guidelines together with unresolved gray area problems involving materiality and the boundaries of the extraordinary relationship test must be handled in a manner different from the present retrospective, ad hoc interpretations by the Commission and courts. When confronted with a difficult question, or perhaps even a fairly obvious one, a no-action telephone system would enable securities professionals to contact the Commission and obtain an administrative opinion as to a proposed course of action. Conduct taken in accordance with such administrative advice would alleviate the industry's concern regarding Commission enforcement action, at least to the extent such assurances are available under the current written no-action method.[115] The

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Stock, 15 N.Y.L.F. 385 (1969) (maintaining that timely disclosure should be required through self-regulatory agencies). But how effective is the New York Stock Exchange or American Stock Exchange in policing their requirements?

114. Even if continuous disclosure is not required some guidelines should be promulgated to enable smaller corporations to achieve adequate public dissemination. ABA Report, supra note 100, at D-3.

115. See Lockhart, SEC No-Action Letters: Informal Advice as a Discretionary Administrative Clearance, 37 Law & Contemp. Prob. 95 (1972). For a discussion regarding an administrative agency's duty to provide standards and safeguards by rule-making or policy statements wherever feasible, see K. Davis, Administrative Law Treatise § 6.13 (Supp. 1970); Friendly, The

system would also provide the Commission with a continuous flow of current data concerning rule 10b-5 problems arising in day-to-day operations of the industry, to be used as a research data base for future policy making changes regarding the rule.

This no-action telephone system has several immediate shortcomings that must be resolved prior to implementation. The system mandates record keeping machinery to preserve the telephone conversations. Permanent tape recordings may be appropriate. Written confirmation by mail or telegram of both the factual problem conveyed and the opinion rendered may constitute an alternative solution. Although this system lacks the speed requisite for activities of the securities professionals, it might reduce divergencies between the Commission's interpretation of the factual pattern as discussed and the nuances of the staff response. Written confirmation, when used in conjunction with the simultaneous recording of telephone discussions, would prove viable and would provide the basis for further administrative review, and if necessary, judicial review,[116] or possible enforcement proceedings by the Commission if action contrary to the Commission's opinion were to be taken.

From the Commission's standpoint two major problems must be assessed: money and manpower, and the ability to provide prompt responses. The Commission appears to be moving away from reliance on the no-action letter system, as manifested by the promulgation of Rule 144,[117] stemming, in large measure, from staffing problems. However, the suggested plan need not deplete Commission resources or burden the taxpayer. If the brokerage industry desires this system, it is only equitable that firms bear the cost. The precedent for providing services funded by industry sources is not unfounded. It is precisely such a special surcharge that funds the Securities Investor Protection Corporation.[118]

Federal Administrative Agencies: The Need for Better Definitions of Standards, 75 Harv. L Rev. 863, 874 (1962).

116. Kixmiller v. SEC, 492 F.2d 641 (D.C. Cir. 1974) (the court declined to review because only a staff report rather than a Commission order was involved).

117. Rule 144 was proposed in SEC Securities Act Release No. 5087 (Sept 22, 1970), [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,909. The rule was subsequently revised. SEC Securities Act Release No. 5186 (Sept. 10, 1971) CCH Special Report No 387 (extra ed., Sept. 15, 1971). The rule was finally adopted with further revision in SEC Securities Act Release No. 5223 (Jan. 11, 1972), [1971-1972 Transfer Binder] CCH Fed Sec L Rep ¶ 78,487 (effective April 15, 1972).

118. 15 U.S.C. § 78ddd-(c)(3) (1970). See Sowards & Mofsky, The Securities Investor Protection Act of 1970, 26 Bus. Law. 1271 (1971); Note, The Securities Investor Protection Act of 1970: An Early Assessment, 73 Colum. L. Rev. 802 (1973).

Even if adequately funded and staffed, could the system generally provide the desired prompt response? Repetitive problems could be speedily disposed of. The strain of resolving difficult gray area questions might prod the Commission to develop guidelines where possible, or else allow the hot-line staff to collectively resolve such questions in the absence of clear-cut standards.