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SOME REFLECTIONS ON RULE 10b-5 AND MARKET INFORMATION

REMARKS OF

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A luncheon speaker has, I suppose, the privilege of viewing matters from a lofty and general level and thus not getting down to the hard "nuts and bolts" questions with which this Course of Study is primarily concerned. He also has the privilege of raising numerous questions without providing any answers. I expect to exercise both prerogatives today.

This program concerns itself with Rule 10b-5, which has become the predominant antifraud provision in the Federal securities laws, and is the basis for numerous and significant legal doctrines and effective rules of conduct for the securities markets. When you think of the number of important areas of the law which spring from Rule 10b-5, such as the responsibilities of insiders, however defined, the fiduciary duties of management to stockholders in such varied contexts as the handling of material information and "going private," and the various ramifications of the broker-dealer's duty to deal fairly with his customers; that is, the so-called "Shingle Theory," you can understand why extensive treatises as well as, perhaps, hundreds of law review articles and notes have been written about one aspect or another of Rule 10b-5. Indeed, in 1961, the Court of Appeals for the

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Third Circuit[1] was moved to conclude that the Exchange Act, with primary reference to Section 10(b) and Rule 10b-5, "constitutes far-reaching Federal substantive corporation law."

This development, of course, is familiar to all of you, but it may be worthwhile to sit back a minute and contemplate it. Certain observers have viewed this luxuriant development of law, largely judicially created, with some alarm. It seems a bit strange that so much is founded upon so little, at least in terms of legislative verbiage. This is particularly surprising in view of the apparently routine and casual manner in which Rule 10b-5 was originally adopted in 1942, at least according to the generally accepted version now enshrined in the Supreme Court Reports as a footnote to the Hochfelder decision.

It has been suggested that this is a peculiar way to go about making so much important law and the process is, at least, offensive to those who would prefer more elegance in their jurisprudence. The proposed Federal Securities Code, which is designed as an elegant piece of legislative jurisprudence, would remedy this defect, if it be a defect, to some extent but really not very much. Professor Loss has concluded

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1/ McClure v. Bourne Chemical Co., Inc., 292 F.2d 824 (C.A. 3, 1961).

that it is both impractical and undesirable to attempt to codify all the law under Rule 10b-5, and, as I will mention later, he determined explicitly to leave certain difficult questions in this area to further judicial development.

This objection to the generality of the statutory sources involves more, of course, than elegance in jurisprudence. It means that the law under Rule 10b-5 changes quite often, that what was regarded as more or less settled law a decade ago may by no means be settled today, and that careful lawyers are constantly troubled by the possibility that some new and unforeseen expansion or development under Rule 10b-5 will suddenly rise up and bite them. These objections have considerable merit. It is troublesome not only to lawyers, but also to businessmen, that you cannot say with complete assurance what the law is, or that it will be the same tomorrow as it was today. This is a real problem, and we should strive for as much certainty and predictability as the subject admits of, and particularly for governing principles which can be applied with some assurance in particular cases. On the other hand, a certain degree of uncertainty is the price we pay for keeping the law responsive to rapidly changing conditions and practices in the securities markets, so that the regulatory pattern and approach will not simply become obsolete.

While I thus have a certain degree of sympathy for those who seek more certainty, there is a good deal to be said on the other side. Antifraud provisions necessarily are a central and indispensable characteristic of any scheme of securities regulation. Indeed, some schemes such as, in large measure, that of the Martin Act in New York, depend almost wholly on such provisions. Securities laws, including the Federal securities laws, are designed, in important part, to protect investors against those who seek to separate them from their savings giving little or nothing in exchange. The securities field is a peculiarly fertile one for operators of this kind because buyers and sellers of securities are dealing in intangible pieces of paper having no intrinsic value. In making investment decisions, investors must rely wholly upon what someone else says, orally or in writing, about the security and its issuer, and that someone else may have considerable incentives to tell investors something other than the truth, the whole truth and nothing but the truth. Moreover, the variety of schemes and devices which may be employed by the fraud doer are almost infinite and the courts have been at pains not to attempt to define fraud. This point has been made by many courts over many years in various ways. Thus, the Supreme Court of Oregon in 1926, explained in a very practical way the consequences of attempting such a definition:

> "a certain class of gentlemen of the 'J. Rufus Wallingford' type -- 'they toil not neither do they spin' -- would lie awake nights endeavoring to conceive some devious and shadowy way of evading the law. It is more advisable to deal with each case as it arises." 1/

Former Chairman Cary put it more classically in the famous Cady Roberts case where he noted that "it might be said of fraud that age cannot wither, nor custom stale, its infinite variety."

We thus have a tension in the law under Rule 10b-5 between desirable stability and necessary flexibility. This perhaps is nowhere better illustrated than in the evolving law of what is referred to as inside information. While the law in this area is firmly rooted in the common law, going back at least to the Supreme Court decision in Strong v. Repide in 1909,[2/] I will start with the Cady Roberts case in 1961, which I think initiated what one might call the modern law of insider trading. As you will recall, the factual situation was basically a simple one. The stock of Curtiss-Wright

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1/ State v. Whiteaker, 118 Ore. 656, 661, 247 Pac. 1077, 1079 (1926).

2/ 213 U.S. 419.

Corporation had been increasing in price in November 1959, because of the public announcement of a new product. On November 25, the board of directors of Curtiss-Wright, which included a Mr. Cowdin who was affiliated with Cady Roberts & Co., a New York member firm, met to take dividend action. They voted to cut the dividend almost in half. Sometime after this decision, Mr. Cowdin telephoned his office and left a message for a partner that the dividend had been cut. That partner, a Mr. Gintel, immediately sold some 7,000 shares, mostly for customer accounts, just before the information came out on the broad tape. In the light of hindsight, this looks like a very easy case, but it did not seem so at the time. There were three principal problems. In the first place, unlike defendants in prior cases, Mr. Gintel did not seek out or solicit the persons with whom he dealt. He did not even know who they were, and he made no representations to them, express or implied. He simply sold on the stock exchange. On this point, a principal common law authority was the 1931 case of Goodwin v. Agassiz in the Supreme Judicial Court of Massachusetts. In the Goodwin case, which incidentally bears a considerable resemblance to Texas Gulf Sulphur, involving as it did a hoped-for copper discovery, the Massachusetts court said that it would be both impractical and unfair to require an insider buying on the stock exchange to seek out the anonymous sellers and give them the undisclosed information and that obviously the sellers were not relying on anything the buyer did or said but had simply decided to sell. The second problem was that Mr. Gintel was a seller not a buyer, and consequently, could be regarded under common law precedents as owing no duty to buyers, who presumably were not existing shareholders to whom the insider might have fiduciary obligations. The third problem was the fact that the insider, Mr. Cowdin, did not sell and the person who did, Mr. Gintel, had no relationship or connection with Curtiss-Wright. The answer to this question now seems obvious. Mr. Cowdin was a "tippor" and Mr. Gintel was a "tippee." The case, however, was not tried on that theory for the simple reason that the concept of tippors and tippees had not then been invented. Rather, it was necessary in some way to assimilate Mr. Cowdin to Mr. Gintel, because both were connected with the same brokerage firm, and to deal with the problem, so to speak, as if Mr. Cowdin and Mr. Gintel were all one, and that the transmission of the information and the use of it were both acts of the firm. I can say with some assurance that this was the basis on which the case was tried and determined, since I briefed and argued it for the Division and, by virtue of the unusual procedures followed, I also had some hand in preparing the opinion. These procedures, which are rather unique in the Commission's jurisprudence, are perhaps worthwhile mentioning because, in a similar type of situation, it might be useful to use them again. The case was regarded as one of first impression in an important area of the law. There was no real dispute between the Division and the respondents as to the facts and these were stipulated. Respondents submitted an offer of settlement in which they waived a hearing and a decision by an administrative law judge and agreed that if the Commission found that there was a violation, it could impose sanctions not exceeding a 20 day suspension from the exchange for Mr. Gintel and no sanctions against the firm, which had had no opportunity to prevent Mr. Gintel from doing what he did. This, incidentally, was before the Commission was given authority to censure people. That came in 1964. Respondents, however, reserved the right to brief and argue to the Commission the proposition that the stipulated facts disclosed no violation in support of which they had a galaxy of leading securities lawyers including a former chairman of the Commission. The Division briefed and argued the contrary proposition. Respondents also agreed that the Division might participate in the preparation of the opinion, thus hopefully expediting disposition of the case, but the Division and the Commission determined to make only limited use of this concession. Full separation of functions was maintained until the Commission had arrived at its decision on the merits, and only after that, did I have any participation in the opinion.

It is interesting and somewhat ironic to note that if we had tried the case on the tippor/tippee theory, which did not then exist, we would have encountered a problem still potentially troublesome in insider trading cases. It appeared that Mr. Cowdin, who died before the proceeding was commenced and therefore was not named as a respondent, believed when he called his office that the information had already been released over the broad tape, since Curtiss-Wright's secretary, an experienced lawyer, was careful not to adjourn the directors' meeting until the information had, presumably, been made public pursuant to stock exchange procedures. There was, however, a foul-up in the internal communications of Curtiss-Wright which delayed the announcement for some 45 minutes. When Mr. Cowdin called, he apparently was merely trying to find out what impact the dividend cut had had on the market. We, thus, could have had the problem of a wholly innocent tippor with attendant difficulties in determining exactly what breach of duty occurred.

The next major step in this progression was, of course, the Texas Gulf case where we did have tippors and tippees.

We elected to proceed against the tippors, but not against the tippees, since we were somewhat concerned as to the theory upon which a tippee would be deemed to violate. The Court of Appeals in the Second Circuit, in effect, invited us to reconsider that issue by noting that while it was not called upon to decide whether the tippee's conduct "equally violated", it noted that such conduct "certainly could be equally reprehensible".

This invitation was accepted in the Commission's decision in the Investors Management case in 1971. The Commission there held that the institutional tippees in that case had violated by selling on the basis of material undisclosed information obtained from an investment banking firm which had received this information in its capacity as a prospective underwriter. It would have been relatively easy to dispose of this case upon traditional grounds on the theory that a prospective underwriter, who must have access to all material information in order to perform his duty of reasonable investigation, is an "insider" and that it was a breach of duty for that underwriter to provide this undisclosed information to the institutions in order that they might trade upon it and then to conclude that the institutions who knew that the investment banker was a prospective underwriter, and had presumably obtained the information in that capacity, knowingly benefited from this breach of duty. However, the opinion of the majority of the Commission went beyond this, in an effort to avoid foreclosing a finding of violation under somewhat different circumstances, and seemingly rested their decision upon the fact that the respondents knew or should have known that the information was non-public and emanated from an inside source. Inherent in the generality of the majority's reasoning is a certain amount of uncertainty as to just how far the analysis in Investors Management might be carried, and as to the exact theory upon which such extensions might be based. There is a hint in the majority opinion that the mere possession of information not available to the person on the other side of the transaction constitutes a basis for a finding of violation, although I do not believe that the case goes quite that far or that it should be interpreted as doing so. Some people who are trading always know more than others do and that, I think, cannot provide an adequate basis for invoking Rule 10b-5.

This brings me by the long way around to the next possible stage in the evolution of insider trading law under Rule 10b-5 and that is the mooted question of "market information". In venturing into this area, I should say with more than the usual emphasis that I am not speaking for the Commission or its staff, or perhaps even my own final position.

The Commission addressed itself somewhat obliquely to this subject in the recent Oppenheimer[1/] case. The Commission quite cryptically stated that

> "There is today no question that the misuse of undisclosed, material 'market information' can be the basis of antifraud violations. Under the circumstances presented here, however, we do not conclude that an adverse finding with respect to this particular respondent is warranted." (Footnotes omitted)

Market information was there defined as information which emanates from non-corporate sources and deals primarily with information concerning or affecting the trading markets for a corporation's securities. The next step will be to devise a theory for distinguishing the circumstances under which the use of market information violates Rule 10b-5 from those in which it does not. This is a task of considerable difficulty. To my mind a principal problem is the fact that trading upon the basis of material undisclosed corporate information may be thought of as without much redeeming social value. On the other hand, imposition of like restrictions with respect to market information could frequently impede the ability of investors to trade for proper and desirable purposes. As I mentioned a moment ago, the concept of equality of information

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1/ Securities Exchange Act Release No. 12319 (April 2, 1976) 9 SEC Docket No. 7.

goes too far. It not only lacks an adequate basis in the law of fraud but is also an impractical standard.

The whole subject of market information was explored in an April 1973, article in the University of Pennsylvania Law Review by three very qualified observers: Art Fleischer, Bob Mundheim and John Murphy. After a very careful analysis, they concluded that the equality of information concept is unworkable and that "there are substantial limitations in using the antifraud provisions of the Federal securities laws to achieve trading fairness." They, accordingly, suggested that the Commission should rely to a greater extent upon specific regulation of undesirable trading practices, particularly by market professionals. These regulations could be based upon the statutory criteria of maintaining "honest and fair markets" which is certainly a more precise tool than Rule 10b-5.

The ventures that we have heretofore made into what could be called the market information area are similarly cautious. The Capital Gains case[1/] is sometimes thought of as a market information case and indeed it was cited to that effect in the Oppenheimer decision. Nevertheless, I think

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1/ SEC v. Capital Gains Research Bureau, Inc. 375 U.S. 180 (1963).

that case rests on a somewhat different foundation. It involved the action of an investment adviser who scalped on the basis of the information which he was about to disseminate to his numerous customers, that is, if he made a bullish recommendation on a security he bought it just before the recommendation came out, while if a recommendation was bearish, he sold. Both types of transactions were reversed promptly after the information came out. The Supreme Court emphasized that this practice compromised the integrity of the adviser, since it had a propensity to lead him to recommend volatile securities which would provide a suitable medium for scalping. This violated the adviser's duty to provide his customers with unbiased advice. The Commission did not charge or try to prove that the adviser's trading, in and of itself, damaged his customers by affecting the prices at which they could buy or sell in conformity with his recommendations. The adviser's trading was too small to have that affect. Thus, the essence of the violation was not the fact that the adviser traded upon the basis of undisclosed information concerning the recommendations, but rather the fact that he breached his duty of loyalty to his customers by engaging in a practice which impaired the objectivity of his recommendations. Thus, the <u>Capital Gains</u> case is in my view more closely related to the "Shingle Theory" doctrine that a market professional must deal fairly with his customers than it is to insider trading principles. The same is true of cases like SEC v. Campbell where a financial columnist traded upon the basis of his forthcoming articles. Such trading compromises his journalistic integrity.

Finally, the proposed Federal Securities Code also ventures rather cautiously in this area. The Code does separate insider trading from its general fraud provision. Insider trading is covered in new Section 1303 which, speaking very generally, prohibits insiders from buying or selling where they know a fact of special significance with respect to the issuer or security which is not generally available and is unknown to the party on the other side. The terms "insider", "fact of special significance" and "generally available" are specifically defined. In his comments on this Section, Professor Loss says that he sees no reason to distinguish between an insider's use of market information and his use of corporate information, and that the Code does not make such a distinction. This comment gives, as an example, information received by the president of a company from a financial analyst that this analyst is about to publish a "buy" recommendation for its stock.

This statement is correct and logical insofar as it goes, but with all respect, it does not go very far. Insiders are defined in the traditional corporate way as the issuer, its officers, directors, parents, etc., people whose relationships to the issuer gives them access to a fact of special significance and finally a class essentially consisting of tippees. Thus, market information is covered by 1303 only insofar as it is obtained by a traditional insider or his tippee. Given the example in the comment, a question arises as to why the president of the company is restricted in acting on the analyst's information, but an institutional investor who receives the same information from the same source is not restricted because he is not subject to Section 1303. The comment explains that this issue is referred back to 1301, the general antifraud provision and that, within the newly provided framework, this area is left to further judicial development.

Since Professor Loss does not purport to come forth with the answer, I certainly will not presume to attempt one. I am left with the conclusion that we will simply have to see what develops in this difficult area, but I am convinced that it is necessary to proceed with caution.